THE FINANCIAL EXECUTIVE AND THE NEW ACCOUNTING

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To my wife Louise

without whose encouragement and patience this book would never have been written

Preface

The purpose of this book is to give financial executives and operating management a convenient guide to all the services they are entitled to expect from their professional accounting advisors—the new profit-building services as well as the more familiar services essential to the continuance and well-being of an enterprise. The book seeks to demonstrate what the individual certified public accountant or the accounting firm can do, how the capabilities of the individual or firm can be judged, and how the company being served can get the most out of the services that are rendered.

One of the principal values of the book should be to suggest the type of inquiries an executive should make concerning the integrity, capability, and resources of his accounting firm.

In planning the book, the author took the rather bold step of asking a group of accounting firms to reply to a series of questions designed to yield a comprehensive description of their practices and experience. The questions covered the more important aspects of the practical operation of an accounting practice rather than matters of accounting principle or auditing methods. The answers to these questions are summarized and illustrated with representative responses. The sample response represented in the book covers a large proportion of the professional accounting work done in this country. Ten international and national firms replied. These firms have offices throughout the country and reflect conditions in all states and in all industries. Thirty-five regional and local firms replied. They range in size from one small office to regional firms with several offices covering several states. Thus all geographic areas and many different types of practice are represented.

The response was greater and the replies fuller than the writer had hoped for. The author is privileged to have this opportunity to thank these firms publicly, even though they must remain anonymous.

While this book reviews briefly the development of the accounting profession in the United States and attempts to appraise its functioning today, it does not attempt to predict what is to come. A caveat of this sort, while it applies to any technical book, is particularly appropriate here, because we are dealing with a profession in the midst of a change so widespread and radical as to constitute a virtual revolution.

For the most part this revolutionary atmosphere is the result of rapid technical developments in computers and data processing that mean not only a vast extension of the usefulness of accounts and records; they mean a thorough-going revision of auditing techniques. Auditing principles remain the same, but the testing and evaluation of the work of a modern computer would have been incomprehensible to the most highly skilled auditor of forty or fifty years ago. In addition to the changes in auditing and record keeping techniques as such, changes in tax practice and government contract work, refinements in budgeting and responsibility accounting, and developments in presentation of financial statements to third parties are taking place so rapidly that accountants and their professional societies are having a difficult time to keep up with them.

This does not mean, however, that all accountants or accounting firms are advancing at the same pace. The geographical location of the firm, the nature of the clientele, the number of offices and size of staff all have a bearing on how the general situation might affect any particular firm. But the real test of the accountant's ability and willingness to keep up with present-day techniques and methods is what is done at the level of the individual. A small or medium-sized firm composed of active, progressive men can be of more help to a client than a much larger firm, if the partners and staff of the latter, for one reason or another, have not taken the time nor made the effort to master the new developments and techniques.

There is nothing mysterious about these new methods, and full information about them is available to anyone. They are, however, difficult and complex and require a great deal of really hard thinking to grasp fully.

In view of the great opportunities that have opened up today, the executive responsible for dealing with the company's certified public accountants should make it a point to find out just what his accounting firm can do for him. If this book succeeds in stimulating such inquiries and encouraging freer communications between businessmen and accountants, the author's purpose will have been accomplished.

MAURICE E. PELOUBET

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Accounting Services Today

A TIME OF RAPID CHANGE

When Rip Van Winkle returned to his little Catskill village after an absence of twenty years, he found a strange, but not incomprehensible, society. Children had grown up, his wife had died, his daughter had married, and George Washington's picture had taken the place of King George's, but people lived in much the same way they did before he played his fateful game of bowls with Henry Hudson's men.

If, however, his absence had extended another one hundred and fifty years, he would have come back to not merely a strange but indeed an incomprehensible society. Automobiles, air conditioning, airplanes, telephones, radio, and television are only a few of the things that not only would have been outside his experience but would have been beyond his comprehension.

If an experienced and well-qualified accountant had fallen into a deep slumber in 1935 and had awakened in 1965, he would have found himself, so far as the changes in his profession were concerned, not in Rip's position at the end of a twenty years' absence, but rather in the position Rip would have been in at the end of one hundred and seventy years of slumber. Many things in the development of the profession in those thirty years not only would have seemed very strange to him but would have been, to a considerable extent, incomprehensible.

For some of the developments, the very terminology would

be new, for example, *cybernetics, binary,* and *PERT*. Other expressions using familiar words would be equally difficult: *operations research, critical path,* and *problem solving by simulation* (see the Glossary, p. 199).

Although the accounting profession has developed rapidly, the pace was hardly quick enough and the innovations hardly radical enough for the process to be called anything but evolutionary, until sometime in the 1940's. From then on the pace quickened; technical, administrative and theoretical breakthroughs were made, and evolution changed into revolution.

Development of Traditional Services

One of the principal effects of the new accounting is the great development of the traditional services to be expected from an accounting firm: audit, the attestation of financial statements for third parties, the preparation of tax returns and contesting disputed assessments, the design and improvement of accounting and control systems, and the provision of expert witnesses on accounting theory and practice.

These have been the functions of the certified public accountant from the beginning of the profession, but as will be seen, they have expanded and developed tremendously in the past ten to twenty years.

Development of Management Advisory Services

Even more significant than these developments are some services of the accounting firm now available to business and government that have been developed in the last few years. These services originate for the most part in the department or group of members of a firm usually called the management advisory services section or division. Many of the smaller C.P.A. firms do not have a formal management advisory services department, but almost every accountant now renders some of these services and has done so in the past.

From the earliest days of the profession, system work of one kind or another has been part of the accountant's work. In the early part of the century, accountants and engineers shared the work of developing cost systems. Henry Lawrence Gantt was an engineer; J. Lee Nicholson and G. Charter Har-

rison were accountants. Frederick Winslow Taylor, the father of scientific management, was an engineer. They and others of that period laid the foundations of cost accounting and were reaching for the beginnings of standard costs.[1]

Although the transition from system work as an adjunct to the audit over to the formal organization of management service departments was gradual and progressed at different rates in different firms, it was in the 1930's and 1940's that the changes were taking effect. The newer types of service went far beyond the system and cost work that had formerly been done.

Even before the opening of broader fields made possible by the computer, the change could be seen in the type of personnel found in these departments. Mathematicians, marketing specialists, economists, industrial and mechanical engineers, personnel consultants, and cost specialists, as well as many men trained in other specialties who would have been quite out of place in the old-fashioned accounting office, were employed, and full use was made of their abilities.

With the advent of high-speed data processing equipment, the potentials of management services mushroomed almost overnight. No longer was useful information unavailable because the cost of obtaining it was prohibitive or because the time required to produce it was so great that it was no longer useful when it became available.

It is an oversimplification to say that computers alone were responsible for the rapid expansion of management service departments; it is nevertheless true that the computer was the greatest single influence in the growth of these services and that without the computer such a growth would have been slow, if indeed it had taken place at all.

TYPES OF SERVICES OFFERED

The following discussions are concerned with the scope of the services that a client may, under present conditions, expect

[1] For a description of the work of Gantt, Nicholson, and Taylor, see Morton Backer (ed.), *Modern Accounting Theory* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1966), p. 14; and for the work of Harrison, see Morton Backer (ed.), *Handbook of Modern Accounting Theory* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1955), p. 311.

from a firm of certified public accountants.[2] Few if any clients will require all the various services, but the financial executive should know what he can reasonably expect when need arises. These services fall into the following principal categories: Management Advisory Services, Tax Services, Audit Services, and Financial Reporting. The first three of these service categories are dealt with later in separate chapters.

Management Advisory Services

The non-accountant may think that the C.P.A.'s chief contribution to the profitability of an enterprise is in the area of taxes, in taking advantage of every legitimate or unchallenged method of reducing taxable income. He would be quite mistaken. In preventing overpayment of tax, good tax advice is conserving profits already earned and realized. Even the best tax counsel, however, must first have the profits to work on. Management services work has for its purpose increasing and maximizing the profitability of the client enterprise.

The cases illustrating management services in Chapter 2 are grouped under the following headings: General Management, Finance, Manufacturing, Marketing and Distribution, Electronic Data Processing, and Administrative Support. Such an oversimplified and unrefined outline cannot properly convey the scope and variety of the services that are available today. If we were to attempt a complete list of the services that might be expected from the large national or international C.P.A. firm, it would run to seventy or more items and include such items as: calculating return on investment; appraising key accounting personnel; suggesting methods of approach to capital markets; developing information in anticipation of acquisitions and mergers; and advising on executive compensation plans, inventory policy, intracompany transfer pricing, coordination of production planning with sales forecasts, preventive maintenance programs, and clerical and administrative procedures.

Smaller accounting firms specializing in certain industries can frequently render important management services. For

[2] The scope and organization of the national accounting firm are indicated in "The Auditors Have Arrived," *Fortune*, October and December, 1960, and "The Very Private World of Peat, Marwick, Mitchell," *Fortune*, July, 1966.

example, in the garment and fur trades an accountant must be able to prepare statements, often monthly, that promptly give credit grantors the information they need; advise the client on organization and overhead matters; and prepare statements for labor unions and confer with union representatives on various provisions of labor contracts. There are many other examples of how a smaller, local firm, familiar with the region or the industry, can be of the greatest value, particularly to the smaller client.

If we should examine the individual items in the long list of available management services, we would see that they all relate in some way to profitability, and that they are also distinctly and definitely for the benefit of the enterprise itself. No liability to the government is considered, as in tax work, and nothing is done for the benefit of third parties; renegotiation of government contracts might appear to be an exception, but even here the purpose is to arrive at a cost on which the reasonableness of a profit is based rather than to determine a liability to the government. Instead, the emphasis is on management's own problems, some recurring and some arising infrequently. Members of the individual management team would be well advised to consider carefully whether the various problems affecting profitability have been satisfactorily solved or whether, in some cases, they have even been recognized.

Accountants' Tax Services and Income

The relation of tax work to income is obvious, and every businessman, from the gas-station proprietor to the president of a corporation of national scope, knows that he must have as good tax advice as is available to him or face either the risk of overpaying his taxes or the equally serious risk of dispute, litigation, and possible fraud charges if he underpays them.

The most basic of tax services is, of course, the preparation of returns so that the statutes and regulations will be properly complied with, thus reducing the chance of unnecessary audits, and so that proper advantage will be taken of all provisions for the computation of taxable income.

Even more valuable may be the contribution the accountant can make to tax planning in estimating the probable tax effect of entering into certain transactions and the effects of alternative methods of handling the same transaction, and in suggesting changes in the form and substance of the transaction where this would result in a legitimate tax advantage. Tax planning is essential, for example, in the purchase, sale, or merger of a business; in the initial organization of a new enterprise; and in the timing and treatment of security transactions for individuals or corporations. The estate planning of corporate officers is sometimes closely connected with corporate affairs, and this is often considered to be a responsibility of the financial executive. The accountant should be a member of the team, along with attorneys and insurance advisors, when questions of estate planning arise. He can also give helpful advice on the organization and administration of the client's own tax department.

Another important kind of tax planning arises when new legislation is proposed. Because of his day-to-day knowledge of client affairs, the accountant can initiate and give advice on appropriate changes in organization, transactions, etc., to put the client in the most advantageous position when and if the proposal becomes law.

In their contacts with taxing and judicial bodies, the accountant may serve clients by advising or representing them in conferences with the Internal Revenue Service and state taxing authorities and by appearing as a witness in the Tax Court or other courts to testify to the facts in a given situation. He may sometimes testify for a party not otherwise a client on the application of accounting principles or trade practices in an industry with which he is familiar.

The organization and functioning of the accounting firm's tax services department is considered in more depth in Chapter 3.

Audit and Investigation

The regular annual audit should not be regarded by the financial executive as a mere routine requirement or a conven-

tional safeguard. Apart from its basic external functions, it is in the course of the regular audit that possibilities for improvements in system and methods and, frequently, opportunities for minimizing various types of taxes are brought to light. There is thus an indirect but nevertheless important connection between the annual audit and profitability.

To some financial officers an audit is like Shakespeare's cat, harmless and necessary. To others, hopefully the majority, it is an objective and impartial review of operations, a source of suggestions for improvement, and a guidepost to those areas of the enterprise that may need more executive attention than they have been getting. It may often serve as a guide to the use of the other capabilities of the accounting firm, particularly in the management services and tax departments.

The basic external function of the annual audit and the auditor's opinion is to make it possible to fulfill the obligations of the enterprise to third parties—stockholders, bondholders, banks, insurance companies, and other credit grantors, as well as various government agencies such as the Securities and Exchange Commission, public utility commissions, and, not infrequently, the Internal Revenue Service. In some cases audited statements are needed in dealings with labor unions.

It is on these third parties that a corporation depends for both its legal existence and its financial nourishment. This is more obviously true of a large corporation listed on a registered stock exchange, but there are few if any small, closely held corporations, partnerships, or proprietorships that do not have some third-party obligations requiring the use of audited financial statements.

A subsidiary purpose of the audit, the detection of internal fraud and the safeguarding of the company's property, is accomplished if enough work is done by either the internal auditors or the independent C.P.A. to ensure that the property and income shown in the financial statements are substantially correct.

Audits are also undertaken in connection with the sale or purchase of a business or the determination of shares in a joint venture, and for such other special purposes as to determine product costs and support insurance claims for fire or other

losses. The difference between special audit work and some features of management advisory services is sometimes hard to define.

The annual independent audit in accordance with generally accepted standards is discussed in some detail in Chapter 4.

Financial Reporting

To Whom Is the Corporation Responsible? The publicly owned corporation and, to a very considerable extent, the closely held corporation, large or small, have a multitude of responsibilities and are under many obligations to people, organizations, and various government agencies. Although these demands are for the most part met by the delivery of goods, the payment of money, or the rendering of service, a financial statement of some sort is a necessary part of meeting the obligation. In some instances it is the financial statement only that is required.

If we assume that the responsible source of the financial statements is the management of the corporation, the directors and officers, then every other person or organization, including the stockholder and the employee of the corporation, is a third party. Although not all corporations are required to furnish statements to all third parties included in the following list, every corporation has an obligation to furnish statements to some of them. Broadly speaking, those to whom financial statements must or may be submitted are:

Owners—holders of common or preferred stocks or analogous equity securities.

Creditors—bond and debenture holders, insurance companies, banks, pension funds, other creditors for loans, and, in some cases, suppliers of materials or equipment or equipment lessors.

Government Agencies:
Internal Revenue Service
Taxing authorities of states or municipalities
Securities and Exchange Commission
Federal Trade Commission
Federal Communications Commission
Interstate Commerce Commission

State and federal public utility commissions
Other regulatory bodies
State security commissions

EMPLOYEES AND UNIONS:
Individual employees
Local and international unions

THE PUBLIC:
Financial writers and editors of daily and weekly newspapers and general and financial magazines.
Financial analysts representing brokerage and investment houses, or organizations representing institutional or private investors.
The management of mutual funds, pension funds, and other institutional investors.

FINANCIAL STATEMENTS FOR THIRD PARTIES. While the statements to be submitted to various third parties are widely different in form and extent of detail, they have two characteristics in common: they are all based on one set of financial books, and these books have been audited by independent C.P.A.'s or will be subject to audit. Nevertheless, they are the statements of the management of the corporation, and the management is primarily responsible for them. This does not mean that the independent C.P.A. is not consulted about form and content even when the statements have not yet been completely audited. This is particularly true of monthly or quarterly statements where the management quite properly wishes to avoid any large adjustment or serious inconsistency between published interim figures and a statement of the results for an entire period.

Any financial statement, whether condensed for newspaper publication or distribution to employees, or elaborated for financial analysts, should be based on and be capable of reconciliation with the corporation's basic accounting records.

STOCKHOLDERS AND CREDIT GRANTORS. The principal financial statement of most corporations is contained in the annual report to stockholders, which consists of a balance sheet and income account and now generally includes a fund or cash-flow statement. In some, details are given of particular items such as capital additions or changes in funded debt.

For corporations the securities of which are publicly held, the report is a public document and is reproduced in whole or in part in financial manuals and magazines and daily or weekly journals.

Annual statements to the Securities and Exchange Commission include the financial statements published to stockholders, occasionally with minor differences in form but none in substance, and certain supporting statements not usually included in the published reports. These, too, are public documents open to public inspection, copies of which can be obtained for a nominal duplicating fee.

When an issue of equity securities is made by an existing corporation, these must ordinarily be registered with the Securities and Exchange Commission and the stockholders notified and permitted to subscribe to the new securities. An initial issue of equity securities must be registered in the same way. Here again, these are public documents.

In agreements with bond and debenture holders, insurance companies, banks, pension funds, and other credit grantors, provision is usually made for the submission of periodic audited financial statements, frequently in somewhat more detail than is required by the Securities and Exchange Commission. Where there are covenants requiring the maintenance of a fixed amount or percentage of working capital or restrictions on the use of the borrowed money, statements showing whether or not these requirements are met are included with the usual financial statements. Sometimes financial statements for individual units in a consolidation, not otherwise required, are prepared for the credit grantor. Where securities of this type are publicly held they must be registered with the Securities and Exchange Commission.

On all of these statements the independent C.P.A. must, if he can, give an opinion as to whether they fairly present the financial condition of the corporation on the basis of accepted accounting principles and a statement that the auditor has carried out all the procedures and tests required by generally accepted auditing standards (see Chapter 4, pp. 71–74).

Government Agencies. There is one government agency to which every corporation must submit annual financial statements—the Internal Revenue Service. A corporate tax return

is essentially a set of financial statements and supporting schedules. They are different in form from the annual financial statements, but the basic data and content are the same. The taxpayer is required to reconcile his taxable income and surplus with his corporate results.

The requirements of the Securities and Exchange Commission have already been discussed, and those of the various state security commissions operating under what are sometimes known as the "blue sky" laws are essentially similar. The auditor must be prepared to show that he meets the specific requirements of the SEC so far as independence is concerned.

The various regulatory commissions and agencies have their own special requirements for information, but they are all based on the financial books, and they differ from the published financial statements in form, emphasis, and amount of detail rather than in substance. The independent C.P.A. must be familiar with the requirements of any government agency under whose jurisdiction his clients (the Interstate Commerce Commission or public utility commissions, for instance) operate and should be prepared to defend his statements and represent his clients before such agencies if need be.

Employees, Labor Unions, and Analysts. Many corporations prepare summarized and more or less informal statements of company affairs and financial statements for employees. These, of course, must be accurate in spite of their informality, and although the auditor does not ordinarily give an opinion on such statements, his advice on form and content may be valuable. Statements for employees sometimes are required. Benefit associations and pension plans generally provide for audits and statements on which the auditor gives his professional opinion.

Agreements with unions may call for audited statements, as do certain needle-trade agreements whereunder the employer pays a penalty for employing non-union help. Some, but of course not all, labor unions are audited by independent certified public accountants, and their financial statements distributed to members.

Financial editors and analysts, either working as journalists or in the employ of financial institutions, are without doubt

both the most difficult and critical readers of financial statements and at the same time the most appreciative of full disclosures and explanations. They feel keenly their responsibility to those who rely on them and, although they wish the corporation and its officers well, feel no duty or even inclination to excuse past mistakes or to gloss over present unfavorable conditions or deficiencies.

A corporation may wish to give more detailed information to analysts representing present or potential credit grantors or to institutional investors in its securities, and here again the advice and experience of the independent accountant may be of great value.

A DESCRIPTION OF PROFESSIONAL PRACTICE

A useful description of the "state of the art" today, which may also serve as an excellent introduction to much of what is to follow in this book, is provided in "A Description of the Professional Practice of Certified Public Accountants." [3] This description was prepared by the Planning Committee of the American Institute of Certified Public Accountants, approved by the Executive Committee, and adopted by Council on October 1, 1966, as an official statement of policy.

Certified public accountants practice in the broad field of accounting.

Accounting is a discipline which provides financial and other information essential to the efficient conduct and evaluation of the activities of any organization.

The information which accounting provides is essential for (1) effective planning, control and decision-making by management, and (2) discharging the accountability of organizations to investors, creditors, government agencies, taxing authorities, association members, contributors to welfare institutions, and others.

[3] *Journal of Accountancy*, December 1966.

Accounting includes the development and analysis of data, the testing of their validity and relevance, and the interpretation and communication of the resulting information to intended users. The data may be expressed in monetary or other quantitative terms, or in symbolic or verbal forms.

Some of the data with which accounting is concerned are not precisely measurable, but necessarily involve assumptions and estimates as to the present effect of future events and other uncertainties. Accordingly, accounting requires not only technical knowledge and skill, but, even more importantly, disciplined judgment, perception and objectivity.

Within this broad field of accounting, certified public accountants are the identified professional accountants. They provide leadership in accounting research and education. In the practice of public accounting CPAs bring competence of professional quality, independence, and a strong concern for the usefulness of the information and advice they provide, but they do not make management decisions.

The professional quality of their services is based upon the requirements for the CPA certificate—education, experience and examination—and upon the ethical and technical standards established and enforced by their profession.

CPAs have a distinctive role in examining financial statements submitted to investors, creditors and other interested parties, and in expressing independent opinions on the fairness of such statements. This distinctive role has inevitably encouraged a demand for the opinions of CPAs on a wide variety of other representations, such as compliance with rules and regulations of government agencies, sales statistics under lease and royalty agreements, and adherence to covenants in indentures.

The examination of financial statements requires CPAs to review many aspects of an organization's activities and procedures. Consequently, they can advise clients of needed improvements in internal control and make constructive suggestions on financial, tax and other operating matters.

In addition to furnishing advice in conjunction with their independent examinations of financial statements, CPAs are engaged to provide objective advice and consultation on various management problems. Many of these involve informa-

tion and control systems and techniques, such as budgeting, cost control, profit planning, internal reporting, automatic data processing, and quantitative analysis. CPAs also assist in the development and implementation of programs approved by management.

Among the major management problems depending on the accounting function is compliance with tax requirements. An important part of the practice of CPAs includes tax planning and advice, preparation of tax returns, and representation of clients before government agencies.

CPAs also participate in conferences with government agencies such as the Securities and Exchange Commission, and with other interested parties, such as bankers.

Like other professional men, CPAs are often consulted on business, civic and other problems on which their judgment, experience and professional standards permit them to provide helpful advice and assistance.

The complexities of an industrial society encourage a high degree of specialization in all professions. The accounting profession is no exception. Its scope is so wide and varied that many individual CPAs choose to specialize in particular types of service.

Although their activities may be diverse, all CPAs have demonstrated basic competence of professional quality in the discipline of accounting. It is this which unites them as members of one profession and provides a foundation for extension of their services into new areas.

August 26, 1966

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Management Advisory Services

THE MANAGEMENT ADVISORY SERVICES DEPARTMENT

An accounting firm's management advisory services department, whatever it may be called officially, is concerned primarily with increasing clients' profitability without regard for third parties or the government. In order to perform this function, accounting firms have developed specialized groups with particular areas of responsibility. These include, among others, general management, finance, industrial engineering, electronic data processing, operations research, marketing and distribution, government contracts, mergers and acquisitions, and international finance. In addition, the staff will include individuals who specialize in the problems of specific industries.

Many of those making up the department have educational backgrounds and experience in accounting and finance; many others have had their training and experience in nonfinancial areas, both within the firm and in industry. These varied backgrounds not only make it possible to undertake the solution of a wide range of business problems, but also permit the accounting firm to draw upon whatever disciplines and skills may be necessary to solve an individual problem.

The work of a management advisory services department is not limited to commercial clients and private enterprises.

Engagements for agencies and departments of our own government, and in the case of firms with an international organization for foreign governments as well, are not at all unusual. Nonprofit organizations, foundations, religious bodies, charities, and the like also have problems with which such a department can assist.

Most accounting firms established for any great length of time have a history of assisting management in industry, government, and nonprofit organizations on a confidential basis. They bring to their assignments a wealth of knowledge and a broad spectrum of information and experience gained in many engagements. They also bring a sympathetic understanding of the complexities and difficulties of operating a business in the modern world.

The executive, before he entrusts his accounting advisors with the solution of particular problems, is entitled to know how the firm—and particularly the management services department—is organized; the composition of its staff, with particular reference to the skills of its members; and the extent, both in depth and quantity, of the firm's experience with similar problems. He is not entitled to and presumably would not ask for data of a confidential nature, but anything he requires to make a decision on the capabilities of his accounting advisors can generally be furnished without violating any professional confidence.

ENGAGEMENT PROCEDURES

Each consulting engagement has its unique aspects; each also has many characteristics common to other engagements. There is value, therefore, in describing in general terms how the services of a consulting organization are rendered in a typical major engagement.

Perhaps the most significant difference between management service engagements as they are now conducted and similar work as it was often done in the past is the continuous cooperation with the client and the client's staff and the emphasis on making the system or the recommendations actually work out in practice.

There are six basic steps to be taken in an engagement of

typical scope and depth. There may be variations in individual cases, but there are few engagements that do not fit into the general pattern.

Step 1—Identification of Problems and Agreement on Scope and Objectives

The first, and in many ways the most important, part of an engagement is to identify problems and opportunities correctly and agree on the scope and objectives of the work to be undertaken. Often the definition of the problem and the determination of the objectives of the study will have been made in advance by executives of the company, at times as the result of problems identified by the accounting firm's audit staff during the course of the annual examination. In other instances, either because the problems have not been clearly defined nor the nature of the improvements identified, or because management wishes an independent evaluation of its own opinions, the accounting firm will make a preliminary survey. This survey may take from one day to a week or more, depending upon the nature and complexity of the problem.

In most instances the initial survey will confirm the diagnosis made by management. There are, however, enough occasions in which the problems and objectives must be redefined—often drastically—to suggest that the preliminary survey in itself has considerable value.

The initial conference with executives or the preliminary survey not only serves to sharpen the definition of the problem and the objectives of the study, but also enables the accounting firm to make sure that its organization is qualified to handle that particular problem. If it is felt that the problem might be better handled by some other organization or that the accountant's competence does not lie in the areas under consideration, the accountant can often help executives by suggesting where they might secure the desired assistance.

Step 2—Development of Preliminary Work Program and Estimation of Time and Cost of Study

On the basis of either the preliminary survey or general experience with certain specific kinds of assignments, the ac-

counting firm will next prepare a tentative work program establish the kinds of skills required to carry out the assignment, and estimate the length of time and the cost that will probably be involved. These initial estimates often must be changed as the work progresses, but they should be made realistic by providing for a reasonable number of unforeseen problems. On many, but by no means all, occasions it is also possible to predict the nature and even the range of benefits that can be anticipated. The accountant should thus attempt to arrive at as sound an understanding of the probable costs and results of the study as his knowledge permits, so that the accountant and his clients will not undertake engagements that will ultimately prove not to be beneficial.

Step 3—Conduct of Study

During the course of the work, the accounting firm follows the usual problem-solving technique of collecting facts, analyzing and synthesizing the available information, developing and evaluating alternatives, and recommending the best alternatives. In doing this, the accountant works closely with the client's own executives and employees in order to obtain their ideas, opinions, and suggestions and the full value of their knowledge and experience. To these are added the knowledge and experience possessed by the accountant's own staff as the result of its participation in similar engagements for a wide variety of clients. At times, the group assigned full time to the study is made up entirely of representatives from the accounting firm; on most occasions, however, client personnel are also full- or part-time members of the study team.

As the work proceeds, the client is kept informed through personal contact and reports as to progress, so that if there should be a need to modify or alter the study or its objectives, or the type and degree of assistance, it can be discussed in ample time.

Step 4—Discussion of Recommendations

As soon as the facts have been established or the problems clarified and recommendations have been sufficiently well developed, arrangements are made to discuss them with client

executives who will be responsible for their ultimate acceptance or rejection. Depending upon the nature of the assignment, the recommendations may vary all the way from indications of a basic problem for further study to detailed recommendations as to actions to be taken or even the specific steps in a procedure. As a general rule, recommendations are presented for acceptance, rejection, or modification at as high a level as is necessary to assure that further work in developing and implementing the recommendations will be productive.

Step 5—Implementation of Improvements

After the recommendations have been approved, the work of detailed development and implementation of suggested changes begins. The extent of the accounting firm's participation in this part of the work may vary from taking virtually complete responsibility for it and providing all of the required manpower to a situation where much of the work is carried out by the client's own staff. Accountants are frequently called upon to act as consultants to a company development and implementation team during this phase of the work, and often find that this arrangement is satisfactory. The main point, of course, is that the implementation team must have adequate skill, motivation, and available time to make the changes well and quickly.

In organizing and developing an implementation program, consideration is given to the relative importance of individual recommendations so that those that make the greatest contribution to the company, either through improving its operating capabilities or reducing its expenditures, receive the proper priority.

Step 6—Review of Results

Periodically during the implementation period and ultimately when it may be considered in most respects to have ended, the accounting firm makes reports to management on the progress made, the benefits gained, and the probable ability of the implementation group to adhere to the original or revised implementation program. These status reports not

only inform on progress but in fact often enable all concerned to form an opinion of the quality of the implementation work and the degree to which the changes being made conform to the purpose and spirit of the original recommendations.

CASES ILLUSTRATING MANAGEMENT ADVISORY SERVICES

The broad range of illustrative cases in the following pages has been included to give the financial and other executives an overview of the field. This will, it is hoped, let the executive know, first, what he should expect from his accounting advisors and, second, what to inquire into to satisfy himself that they can come up to his expectations.

The cases generally involve a particular problem of primary interest or importance. For ease of reference, they have been grouped according to these problem areas:

General Management
Finance
Manufacturing
Marketing and Distribution
Electronic Data Processing
Administrative Support

All of the cases are based on actual engagements. To maintain the book's confidential character, however, in no instance are significant data provided sufficient to identify the company or organization involved.

General Management

Case No. 1 — Centralization of Common Administrative Functions in a Divisionalized Company, Resulting in a Large Cost Reduction

The Problem

This company had always followed the policy of assigning to the management of each of its five wholly owned divisions the full responsibility for profitable operation. This responsibility included the development of the most effective and most

economical administrative and clerical methods, and the installing and carrying out of procedures in an efficient manner.

Although this policy had been producing satisfactory results, the cost of performing administrative and clerical functions exceeded the benefits derived from following administrative procedure specifically designed to suit divisional practices that had been individually designed over several years.

The Approach

The accountants were asked to review the company's policy and to make recommendations. The only restriction, which the accountants themselves placed upon this work, was that any changes in organization or procedures would in no way diminish the ability of division executives to continue to manage their operations in an effective and independent manner.

Although the primary problem involved might be considered a simple question of centralization vs. decentralization, a review indicated that the objective of the company, essentially cost reduction, could best be achieved by a separation of administrative and clerical functions into "common" functions and "local" functions.

The common functions were considered to be those that showed great interdivisional similarities and might, therefore, lend themselves to interdivisional processing. In these functions the *results* obtained rather than the *means* or methods of performing these functions were of more concern to management. The local functions consisted of those activities that could not easily be removed from the division, district, or office. The major cost reduction in this area was obtained through improved methods and procedures. The major common functions were:

1. Purchasing (partly)
2. Accounts payable
3. Payroll
4. General ledger
5. Accounts receivable

The major local functions were:

6. Purchasing (partly)

7. Order entry and billing
8. Costing of production and sales, and control of inventory

What Was Done

An inventory was taken in over forty locations through questionnaires on (1) the type of functions performed, (2) the method of performance, and (3) the personnel and equipment assigned to each. The cost of performing such functions was then determined. The results of this "inventory" formed the basis for conclusions on the magnitude of costs, the effectiveness of existing methods, and the savings potential that existed. Functions and situations with the most promising potential for effecting savings and improving productivity were then selected, and these became the subject of intensive further studies, which ultimately resulted in substantial changes in methods and often total elimination of certain work when it was determined that outside organizations, such as banks, were glad to perform them at little or no cost to the company.

Benefits

The estimated reduction in personnel in the *common* function areas was 70 to 90 employees, a reduction of between 30 and 35 per cent, extending over a period of two years. A progress report prepared by the company showed a reduction of 52 employees one year after installation of the program.

The estimated reduction in personnel in the local function area was 20 to 50 employees, or between 5 and 10 per cent, extending over a period of two years. A progress report prepared by the company showed a reduction of 15 employees one year after the installation of the program. Total cost savings amounted to $420,000.

Case No. 2 — Reduction in Manufacturing Costs and Sales Expense in Anticipation of a Severe Decline in Volume

The Problem

Competition and the cost-and-profit squeeze had begun to force an old established manufacturer of high-quality products to shift a significant portion of its production of exported

products to overseas affiliates. In addition, changes in product and other causes were beginning to result in substantial volume reductions that were likely, if they continued, to lead to further shrinkage of production and profits in this country.

The Approach

The accountant carried out studies in two general directions. The first involved analyses of savings to be made in the United States operations. The second involved research into the effectiveness of the company's present sales operations. A brief analysis of the company's operations showed that the bulk of the company's costs were incurred in plant operations in several locations in the United States. Further analysis of these costs showed that they were excessive in two primary areas: operation of costly equipment and quality control.

What Was Done

Industrial engineers developed new standards for equipment operations and productivity, while operations research specialists developed new, feasible, and much more economical approaches to quality control. These standards and approaches were tested in a number of controlled experiments and finally adopted.

The accountant's staff identified opportunities for savings in manufacturing expenses in excess of $1 million per year. Some of these savings suggestions were adopted immediately; others required major changes in the company's organization and office location. Some of the potential savings identified by the accountant's industrial engineers and operations research specialists had been analyzed time and again by the company as well as by other consultants and had previously been discarded as damaging to the quality of the product. By using new approaches, the accountants were able to demonstrate that these changes could indeed be made without sacrificing product quality.

The relative effectiveness of the company's sales operations was analyzed by marketing specialists, and on the basis of their work the company adopted a number of major suggestions in such areas as sales training, sales compensation, frequency of customer contact, and sales supervision.

Benefits

Many of the accountant's suggestions have been implemented, but fortunately the anticipated volume decline did not occur to the extent the company had feared at the time the study was made. Nevertheless, the company now has a blueprint of additional savings that can be realized should the existing situation worsen.

Case No. 3 — Drastic Cost Reductions and Improved Management Controls Buy Time To Survive Despite Technological Obsolescence in Products

The Problem

A major division of one of the country's largest manufacturers of transportation equipment was faced with potential dissolution because technological changes were making its principal product virtually obsolete. Annual sales of this product had been substantially in excess of $100 million, and costs and expenses were geared to that volume.

The Approach

It was agreed that strenuous reduction of costs was vital during the period required for conversion to new product lines.

What Was Done

Budget Control. A detailed budget for each department was prepared for the ensuing fiscal year. Each was based on anticipated sales, and virtually all called for substantial cuts. It was stressed that each department manager had to accomplish the reduction called for by the close of the current fiscal year. The division manager, with whom the accountant had frequent meetings, refused to accept anything less.

Manufacturing and Production Control. The accountant reviewed, and made recommendations to improve, procedures for preparing operations sheets, setting standards for the operations, and ascertaining that manufacturing processes were then carried out accordingly. Production control procedures and organization were reviewed, and the establishment of a

centralized and broadened production control department was recommended as was the hiring of a new production control department head.

Cost Accounting. The accounting firm designed and helped install revised cost accounting procedures involving establishment of logical cost centers, controlled by identifiable individuals. Provision was made for gathering costs and identifying variances from standard by cost centers.

Conversion to Mechanized Procedures. General and administrative procedures and costs in all departments were reviewed to identify and eliminate waste and to plan conversion to mechanized procedures where this appeared advantageous.

The budget was the essence of the cost reduction program. The other elements in the cost reduction program were necessary to long-range health, but the relentless pressure for cutback, amounting to about 30 per cent of the personnel, was the vital action to keep the division going.

Benefits

The reduction of costs and expenses and the conversion to new product lines were accomplished. The division entered upon a new period of successful and profitable operations.

Case No. 4 — Timely Reports for Control of a Large Chemical Company

The Problem

Shrinking profit margins and the inability of the accounting system to furnish meaningful and timely data for analysis of the problem led to this chemical company's interest in improving its accounting system. Marketing of the products was centered around the fifty manufacturing locations.

The Approach

A survey was conducted by three accountants and a computer specialist to identify the problems and to outline the scope and objectives of the work in a written proposal to management.

After the proposal was agreed to by top management, the work was divided into three projects planned and controlled by the C.P.A. firm. Periodic progress reports were made to a steering committee consisting of top management representatives.

What Was Done

The three projects were (1) design and installation of a new cost accounting system, (2) development and introduction of a new series of sales reports, and (3) improvement of the basic accounting system.

The goals sought in the cost accounting system were more accurate information about product costs for use by the marketing department, cost control information, and improved information for planning future activities. The sales reports were designed to show profit contribution as computed under the new cost accounting system by product, product group, salesman, and customer. The most notable of the improvements in the basic accounting system were in the area of computer methods for processing the data required by the cost and sales information systems.

Each project was carried out in two broad steps: the design phase was approved by management before the installation phase was begun; and each project was led by a specialist and made use of full- or part-time company line and staff personnel as required.

Both the cost system and the sales reporting system were designed for a pilot plant that exhibited most of the representative problems to be solved. The cost system was completely documented, and a team of "installers," consisting of internal auditors and representatives of the C.P.A. firm, was trained for introducing the system into the remaining forty-nine plants one at a time. The same "installers" assisted in preparing instruction manuals for each plant on the preparation of source documents needed for the centralized computer processing of sales reports. The sales reporting system was installed in the individual plants in the same sequence as the cost system. The improved basic accounting system was run on a parallel basis until satisfactory computer processing allowed the older system to be discontinued.

Benefits

The availability of the new information has brought the manufacturing operation under positive cost control with the aid of responsibility accounting and flexible budgets. It has also allowed the marketing department to analyze its relatively unprofitable products, salesmen, and customers, leading to a thorough reappraisal of the marketing policies and practices and to definite action with respect to marginal salesmen and products. The accounting system now efficiently provides the information that management needs to plan improved operations and obtain timely, accurate reports on results for comparison with its plans.

Case No. 5 — A Management-Improvement and Profit-Improvement Program for 350 Small-Business Customers of a Manufacturer

The Problem

A manufacturer and distributor of laboratory supplies decided to sponsor a program to develop procedures and techniques that would improve the operations and profits of its 350 small-business customers.

The Approach

The accounting firm was asked to study the operations of a number of these customers throughout the country to determine the reasons why certain of them operated more successfully than others.

Reviews of two successful and two unsuccessful operations were made initially, and these revealed that the operating philosophies and procedures of the profitable laboratories differed greatly from those of the unprofitable ones. Arrangements were made to expand the sampling of laboratory operations. Questionnaires were sent out and data obtained by visiting the cooperating laboratories.

What Was Done

From these visits, there developed a profit improvement program that was presented directly to the company's custom-

ers at regional meetings and in a series of newsletters. This program included specific steps to be taken to:

1. Estimate future sales.
2. Set a labor/sales ratio target based on data derived from the study of profitable concerns.
3. Determine the number of daily units of work per employee required to achieve the desired labor/sales ratio.
4. Install simple production control procedures to schedule work and obtain the necessary output per employee.

Benefits

From customers who adopted the recommended program, the client has received a number of testimonial letters reporting cost reductions ranging from 10 to 30 per cent. A number of customers noted that they have started earning reasonable profits for the first time in several years.

Case No. 6 — Production, Maintenance, and Financial Controls for a National Petrochemical Industry

The Problem

A government-owned petrochemical complex requested assistance in improving its cost system.

The Approach

The team of specialists assigned by the accounting firm to the engagement included an engineer, an accountant, and a data processing specialist. It was soon established that there were excessive maintenance costs due to lack of controls. The cost system failed to provide an adequate account structure, and there was no agreement on the basis for allocation of costs between departments. There were no standard reports of production and consumption.

What Was Done

As a result of the specialists' work, a complete maintenance job-order and cost collection and reporting procedure was established, production reporting systems were drastically modified, and a mechanized financial reporting system was

introduced that permitted simultaneous handling of accounting and budget reports. Improved material control and cost and general accounting reports were provided.

All maintenance was centralized in one department. The new cost system provided written procedures and forms for maintenance cost accumulation, and written reports were provided for all interested departments. To achieve greater accuracy in cost collection, additional measuring devices were installed, and new, more useful accounts were set up.

Data processing was modified in order to provide integrated processing, for all purposes, of source information and to assure timely distribution of reports.

Benefits

Production personnel are now receiving operating cost statements for the first time, and the client expects that the system will result not only in better cost information and improved operating efficiencies but also in a substantial reduction in maintenance costs.

In addition, improvements in punched-card procedures resulted in the elimination of six keyboard accounting machines and operators without increasing data processing personnel, as well as achieving the benefits of better reporting and control.

Finance

Case No. 7 — Reorganization of Securities Clearing in a Major Investment Bank

The Problem

The administrative management of the client, a major, multi-office investment-banking firm, became alarmed at high clerical costs and poor service to the firm's customers during the latter part of 1961, a record year in terms of underwriting activity and trading volume. It was decided that outside assistance was required, and an accounting firm was requested to proceed with a study.

The Approach

An initial review was completed, and the accountant's recommendations were presented to a committee composed of president, administrative vice-president, vice-president of the corporate department, and comptroller. In addition to specific measures designed to control costs and improve service, the accountant recommended a reorganization of the functions and responsibilities of the treasurer and the comptroller. The committee approved the recommendations, and these were implemented over a period of about six months.

What Was Done

After a detailed analysis of the work done by clerical and administrative personnel, the accountant instituted revisions in office layout and more effective clerical procedures. The latter involved the elimination of a punched-card installation and its replacement by bookkeeping machines. The accountant designed new forms (and followed through on their printing and delivery) and developed recommendations for filing and retention of documents. Assistance was also given on the development of a revised chart of accounts and related financial statements and reports.

Branch office procedure manuals used in the security operations function were reviewed and revised, and training meetings were conducted to indoctrinate branch office personnel.

Services were further improved by the termination of arrangements with banks for securities clearance and the setting up of two regional cages for taking inventory of and clearing securities. Cash requirement planning was improved, thus reducing the daily demand loan balance (by several millions of dollars) and the attendant substantial interest cost.

Benefits

The new regional cages accelerated delivery of securities and simplified the planning of cash and loan requirements. The result was a decrease in demand-loan interest charges of about $200,000 per year and in clearing costs of $60,000 per year. The improved internal clerical procedures saved about $40,000 per year and the elimination of equipment rental and maintenance costs for the punched-card installation some

$6,000 per year. Total savings, then, were about $360,000 annually.

Manufacturing

Case No. 8 — Integrated Planning for Sales, Production Schedules, and Inventory Levels

THE PROBLEM

A metal fabricator had followed the practice of maintaining relatively low inventory levels at many locations and providing rapid deliveries to customers. As a result, long production runs were frequently interrupted to manufacture small quantities of another product. Under these policies the number of employees fluctuated between 160 and 420. Because a recently negotiated labor contract called for a substantial supplemental payment to each employee laid off, the treasurer requested that the accounting firm develop a plan that would help to stabilize the work force without impairing the high level of customer service.

THE APPROACH

Many fact-gathering sessions were necessary to gain sufficient knowledge about the plant operations to isolate the source of difficulty. It was determined that the factory reacted to changes in demand as quickly as possible. "Reacted" and "as quickly as possible" were the key phrases in describing the old system. The plant operated on a "job order" basis.

The lead time for ordering raw materials was two to three months. In addition, direct labor availability was a material factor in the ability of the plant to vary production to meet demand changes.

An analysis of historical demand patterns indicated a cyclical demand with peaks during the late summer months. It was also determined that 40 per cent of the products accounted for 5 per cent of the sales dollar volume.

WHAT WAS DONE

It was concluded that the peak of demand could be met in two ways: (1) large inventories of raw materials could be

purchased, and as sales increased the factory could hire personnel to satisfy the demand; or (2) the factory could maintain its current level of raw-material inventories and a labor force slightly larger than required in the early months of the year and build up a product inventory that, when combined with production in the peak months, would satisfy the peak demand. Incremental costs associated with each alternative were calculated on the basis of historical cost information and the new labor contract. The second approach was proved to be the most economical.

A year's supply of those items producing 5 per cent of total sales is now manufactured at one time and stored. Sales estimates for the remaining 60 per cent of the products are translated into monthly product requirements, either to be shipped from inventory or to be produced for customer orders. These estimates are the basis for computerized inventory and production planning. Inventory control records are used to determine when economic-size internal stock orders should be entered into production. The production scheduling system provides for advance planning to achieve stabilization of the work force and economic inventory levels while satisfying customer service requirements.

Benefits

Adoption of these techniques has resulted in annual savings of approximately $200,000 through reductions in costs of material procurement, labor turnover, and machine set-up.

Case No. 9—A Simplified Inventory Control Procedure

The Problem

During the course of the annual audit the accounting firm had occasion to review this client's inventory control procedures and felt that there were very definite opportunities for clerical cost reduction and improved inventory control.

The Approach

The accountant obtained the client's approval to make a survey and submit recommendations. As a result of the survey

it was concluded that the cost of the present punched-card inventory control procedure, using service bureau facilities for card processing, was not justified by the results and that control of inventories at retail value could adequately meet the needs of individual stores and the central warehouse.

A proposed manual control procedure was designed and submitted to the client's president. He had had a bad prior experience with manual systems and questioned the proposal. The accountant described the procedure step by step, and time standards were used to estimate time and cost. This detailed evaluation convinced the president, and he approved the system for installation.

What Was Done

Control procedures were concentrated at the client's main warehouse, manual records were substituted for the punched-card system, and economic inventory lot sizes were established. Control of inventories at retail value eliminated the need to keep track of the quantity and cost of each item at each store and simplified the data processing requirements.

Benefits

The new manual procedure produced a number of advantages, including substantial clerical savings. Inventory control costs were reduced by $36,000 per year, the number of out-of-stock items was significantly reduced, and the capital tied up in slow-moving items was reduced about 20 per cent in less than six months.

Case No. 10—A Mathematical Method, Using a Service Bureau Computer, for Evaluating Extent and Location of New Production Facilities

The Problem

The increased demand for this company's product was forcing a decision as to the most advantageous location of additional production facilities, primarily automated packaging equipment. The product was manufactured at six geographically separated plants, four of which at the time already had automated equipment. The problem posed by the client was

to determine whether all plants should continue to manufacture this product and which plant or plants required additional facilities. This problem also involved the assignment of customer orders to plants in a way that would minimize both production and transportation costs.

The Approach

The solution to this problem required more than just a consideration of minimum transportation costs. It entailed the relative freight and production cost savings subsequent to the location of additional production facilities at a location still to be determined.

A mathematical business model was developed that took into consideration forecast volume and production costs, transportation costs, and plant capacities, depending on assumed location of additional facilities. Because of the number of calculations required to determine minimum production and transportation costs, the problem was programmed for solution on a high-speed electronic computer using service bureau facilities.

What Was Done

First, the necessary "input data" were collected, consisting principally of:

1. *Forecasted demand* for each item.
2. *Freight rates* from each plant to each storage point or customer.
3. *Production costs* for each item, by plant, stated as standard direct costs.
4. *Production rates* and capacities for each item of equipment.

With this data, an existing Linear Programming "library" program was used, after appropriate modification, to produce a computer run showing (1) total variable costs of manufacturing and distribution using the *historical* pattern, (2) total variable costs of manufacturing and distribution using the mathematically derived *optimum* pattern, and (3) savings results from the differences between (1) and (2).

The computer model not only was found useful for decision making involving new equipment, but also provided a basis

for scheduling all of the production facilities centrally instead of by the former plant-by-plant, intuitive process.

BENEFITS

The solution of the business model, which was developed in cooperation with client personnel, indicated that automatic packaging equipment should be installed in one of the plants that had theretofore had no such equipment, and that production of the product should be discontinued at one of the six plants. The company subsequently put these recommendations into effect. No estimate of saving was made, although comparative cost figures indicated that the full cost of the additional equipment ($350,000) would be recovered within two years.

Case No. 11 — Revisions in Plant Layout, Processing Equipment, and Materials Handling Facilities that Tripled Production Without Increasing Employment

THE PROBLEM

The initial work for this client, which makes large panel plastic signs, was to provide engineering plant-layout assistance in effecting a fifty-per cent increase in floor space. Despite the added floor space, the continued increase in the company's sales was causing serious production bottlenecks in certain departments. As a result of the experience gained on the first assignment, the accounting firm was requested to extend its work to other operating functions, including operation and equipment analysis, and production and inventory control.

THE APPROACH

During a three-year period the accounting firm provided industrial engineering consulting and skills not available from company personnel, averaging about four days per month on the job.

WHAT WAS DONE

The production bottlenecks were overcome by design changes in heating ovens and press-room equipment, improved

material handling procedures, specially designed easy-access storage bins, and an overall decrease in product cycle time.

One cause of inefficiency was that working crews had to spend much time walking back and forth among individual sign panels and tool or material locations. Simple dollies were constructed in which appropriate tools, fasteners, and small service materials were placed. Work place layout was also redesigned. Workers were thus permitted to move progressively from panel to panel, bringing their tools, materials, and supplies with them.

Other improvements the accounting firm developed involved such simple matters as using a vacuum cleaner to pull debris from signs so as to eliminate previous hand brushing, use of spraying devices to replace hand work, and use of scheduling techniques to facilitate the best utilization of personnel. In some instances, entire departments were rearranged to provide a smoother flow of work and minimize interference with operations or potential product damage.

Benefits

At the end of the three-year period, the client had achieved three times the production volume with the same number of employees. No attempt was made to estimate cost saving.

Marketing and Distribution

Case No. 12 — An Integrated System of Sales Forecasting, Production and Manpower Planning and Scheduling, and Inventory Control

The Problem

A large manufacturer of heavy machinery asked an accounting firm for assistance in developing an inventory management program. This included the development of a sales forecasting system that could be integrated into production scheduling and inventory control. Previously these forecasts had been made on an informal judgment basis.

The Approach

The development of a sales forecasting system involved a thorough analysis of historical sales data, using the capabilities

of a computer, and consideration of the various marketing factors that might influence sales. Various statistical forecasting techniques were tested against historical data before the final procedure was determined.

The first phase in developing the integrated production planning and inventory management program involved a survey of current operating methods and various restraints that might influence future operating systems. The second phase was concerned with the design and testing of alternative methods and systems. The final phase included the development of an implementation plan and the means of administering such a plan through assigning project responsibility and the reporting of progress.

What Was Done

The sales forecasting system adopted uses statistical methods and data processing equipment and emphasizes the forecast of final demand (dealer sales) because of its effect on the different inventory levels and production rates. Charts reflecting sales data, the statistical forecast, and projected inventory levels are prepared monthly. A management committee reviews the charts and a list of abnormal factors (not included in the statistical analysis) monthly, and prepares the necessary adjustments to the statistical forecast.

The resulting inventory management program, which also makes use of EDP equipment, produces a detailed monthly forecast by model. It takes into account the goal of maintaining a relatively constant labor force; the variable cost of carrying inventory; the variable cost of processing a production order and the related factory set-up cost; the variable cost associated with a purchase order and the influence of quantity price discounts; and the level of service, in terms of delivery lead times, required to maintain a competitive market position.

Benefits

This inventory management system resulted in sizable cost reductions that could be readily identified, especially in connection with taking advantage of quantity discounts. In addition, and of great long-range importance, there was increased knowledge on the part of company personnel and manage-

ment about the use of mathematical and statistical techniques in these areas and a more comprehensive understanding of the interaction of various functional areas within the company.

Case No. 13—Profitability Studies

THE PROBLEM

A prominent advertising and public relations firm that specializes in serving banks, insurance companies, and similar institutions had become concerned about (1) the cost and profitability of its services, (2) the adequacy of public relations retainers and advertising fees, and (3) the possibility that many of its smaller clients were receiving services substantially beyond the income derived from the standard 15 per cent fee arrangement.

THE APPROACH

The work involved essentially a calculation of the cost of servicing clients and comparing this cost with revenues obtained. Part of the initial approach was to install a time-recording system for all executive, creative, and clerical personnel of the agency. Subsequently there was a department-by-department analysis of the relative productivity of creative and non-creative functions. This led eventually to (1) the assignment of time and expenses to specific client accounts and (2) the determination of desirable levels of productivity, primarily in the creative departments.

The results of these analyses quickly disclosed services and accounts that were clearly unprofitable as well as a substantial unused creative capacity on the basis of reasonable rather than excessive standards of creative quality. Some of the specific findings showed that:

1. One service was highly unprofitable, and if it were to be continued, substantial changes would have to be made in setting retainers and fees.
2. Another type of service contributed practically all of the agency's profits. In some instances clients in that service category were undoubtedly too profitable.

3. Over the years the agency had accepted a number of small clients who were highly unprofitable and had probably been unprofitable from the beginning.
4. Account executives, never having been informed about the relative profitability of their specific clients, insisted on a standard of perfection in artwork, copy, etc., that was much too costly for the type of advertising involved or agency commissions obtainable.

What Was Done

Provided with these facts, the agency's management made substantial changes in its fee structure, its personnel, and its service standards. It also dropped a number of clients when it became evident that even relatively substantial increases in advertising budgets would not materially improve the profitability of such clients.

Benefits

After the suggestions of the accounting firm had been accepted and put into effect there were substantial profit increases for at least two of the three services. The over-all period profit doubled in comparison with that of the preceding year.

Electronic Data Processing

Case No. 14—A Comprehensive, Long-term EDP Development Program

The Problem

A large and fast-growing life insurance company with a well-earned reputation for progressive management sought to develop a comprehensive and efficient EDP system to support its extensive insurance operations. To bring experienced guidance to the project, the company asked the accounting firm to work with its own staff on the project.

The Approach

The accountants played an important part initially in setting the direction of the study and, in addition to carrying out a

number of specific project tasks, regularly reviewed the results of work by the company representatives. The study report, prepared jointly, recommended an extensive systems development effort to be carried out over a five-year period.

As a first objective, the available alternatives were thoroughly evaluated, and a proposed course of action and timetable were developed for approval by top management. The plan included applications, priorities, systems features, equipment, organization and staffing for installation, estimates of the effect on operating costs, time and cost to complete, and conversion plans.

A study team was organized consisting of a partner, manager, and two data processing specialists from the management services department of the accounting firm, together with ten systems and data processing specialists from the client's staff. The team was headed by a vice-president with much experience in company operations and in previous planning studies.

The team was divided into two main groups, one to study the life insurance application and the other to study the group insurance application. In each case, the application requirements were defined, a computer system was designed in sufficient detail to permit evaluation of equipment and programming requirements, and cost and savings estimates were prepared. Proposals were obtained from several computer manufacturers and carefully evaluated. Throughout the work, the client staff relied heavily on the more extensive experience and knowledge of the outside specialists for guidance and direction.

What Was Done

The proposed program, which was presented in considerable detail, was adopted in its entirety and has since formed the basis for the company's highly successful data processing activities.

Benefits

Actual accomplishments have been essentially as planned and have been completed very nearly in accordance with the original timetable.

Case No. 15 — A Computerized Production Order System

The Problem

A metal products manufacturing company with a medium-scale electronic data processing installation was concerned with the relatively high cost of entering production orders and obtaining prompt and accurate reports on the status of these orders. The accounting firm was asked to determine what parts of subsystems of the production order processing system could feasibly be done with EDP, design those feasible, and help to install them.

The Approach

At the outset of this assignment, study of existing procedures and the design of the EDP system was carried out by a task force composed of the production control manager, time study manager, chief timekeeper, assistant data processing manager, and an assistant controller representing the company and three specialists (EDP, Cost, and Systems) from the accounting firm.

All initially proposed procedures were flow-charted and supported by written descriptions. These were presented and discussed at meetings held with key departmental employees. The meetings resulted in many worthwhile suggestions for improvements, and the proposed procedures were modified accordingly. Similar meetings were then held with department heads and executive management, at which the proposed system was presented in condensed form and required changes in company policies were fully discussed. Approval of the system and agreement to issue revised policies were obtained as a result of these meetings.

What Was Done

After the initial study, the following jobs were converted to the electronic data processing equipment:

1. File maintenance of master process sheets.
2. Entry of production orders and scheduling of all operations to meet promised delivery dates.
3. Preparation of associated labor and move tickets, material requisitions, and tool and pattern withdrawal tickets.

4. Work-in-process reporting of all production orders for both foundry and machine shop.
5. Timekeeping and payroll for direct labor, on both piecework and daywork, and for all indirect labor in the plant.
6. Loading of work stations.
7. Analysis of labor distribution.
8. Development and updating of manufactured parts standard costs.
9. Analysis of causes of bad foundry castings.

A staff of EDP programmers was recruited from within the company. These individuals were trained in programming by the equipment manufacturer and proved to be excellent programmers.

The actual implementation was carried out by company personnel with operating experience in the departments under the general supervision of the accounting firm's representatives. Company personnel involved in the installation were given thorough training in the new procedures and were provided with written copies of the new procedures and with examples of completed forms. The success of the engagement was undoubtedly increased by the required participation of key personnel of the operating departments.

Benefits

Carrying out these recommendations has resulted in reduced operating costs for the company, fewer errors in production reporting, better information for operating management to use in scheduling production, and reduction in time spent by department foremen in planning manpower and machine requirements.

Case No. 16 — EDP Review for a New Manager Disclosing Major Weaknesses in Controls, Organization, and Programming

The Problem

Recently the corporate EDP activities of a large, multidivisional corporation were transferred to a separate department reporting directly to a vice-president. An executive from

one of the divisions who had experience with the use of EDP equipment was placed in charge of the new department. He requested that his accounting firm review the audit trails and controls surrounding the use of EDP equipment at corporate headquarters and provide him with comments on any other observations the accounting firm was able to make during the course of this work.

The Approach

A manager from the accounting firm's management services department with more than ten years' experience in data processing systems was assigned primary responsibility for carrying out the review. He conducted a series of interviews with members of the client's data processing services staff and with representatives of user departments to find out what control procedures were being followed and what audit trails were being produced.

Much useful information was also obtained from members of the firm's audit staff who had extensive knowledge of the client's operations and many observations and ideas to offer from their firsthand experience with the client's systems. Wherever control weaknesses or audit trail deficiencies were found, specific recommendations were developed for correcting them.

The manual controls established over inputs and outputs at the corporate data processing center were reviewed and found to be both elaborate and costly to operate. Control and scheduling of work through the data processing center were left almost entirely to individual operators. Operating instructions and program documentation were almost non-existent, requiring that an operator learn specific applications and then follow these applications through the center. Little control was exercised over the magnetic tape library and the computer programs, with the result that tapes were difficult to locate and program changes were sometimes made very informally.

A review of audit trails and controls disclosed that elaborate manual measures were being used to compensate for poor systems design and programming. Internal machine controls were seldom incorporated in the programs; this resulted in excessive manual effort; most programs were copies of the previous pre-

computer procedures, with no effort made to take advantage of the more powerful capabilities of the equipment.

WHAT WAS DONE

It was apparent that these situations should be changed, and the company immediately embarked on a project to improve program documentation and operator instructions and to install a production scheduling system. Tight controls were instituted over tape and program libraries. Organization of the computer center was changed to provide a more effective division of duties and responsibilities. Substantial effort was devoted to system design to achieve far greater integration of processing and use of internal machine control capabilities.

BENEFITS

The over-all result was greater accuracy and increased speed of processing, and also substantial reduction in the extent and cost of manual controls.

Thus, an engagement that started as a special review of audit trails and controls provided benefits far beyond any expectation of the accountant or the client. Not the least of these benefits was freeing this large company from the danger of being unable to process important data because a computer operator had left without training a replacement.

Administrative Support

Case No. 17 — A Cooperative Administrative Study that Eliminated Duplicate Functions and Records, Internal Friction, and Excess Costs

THE PROBLEM

The financial vice-president of this client was quite satisfied with his operations but felt that something might be gained by an independent outside review, and the accounting firm was given complete latitude to investigate all phases of his accounting and related functions.

THE APPROACH

This work was undertaken in cooperation with the client's systems and procedures unit. The review indicated that company procedures and accounting organization were highly

effective. A considerable portion of the efforts of the accounting firm, and major recommendations for savings, were devoted to those areas of accounting reporting that originated outside the accounting department and caused duplication of effort and records.

A survey team, composed of a representative of the Management Advisory Services Department of the accounting firm and three of the client's systems personnel, developed an approach that allowed them to cross freely any and all departmental jurisdictions, with the advance approval of the president.

What Was Done

This approach made possible the following major types of improvements:

1. Consolidation of several organizational units, in accounting as well as other administrative departments, and elimination of supervisory and procedural duplications.
2. Consolidation of two large and theretofore independent data processing installations and personnel. (One such installation had used only a fraction of its capacity.)
3. Streamlining of procedures so that most transactions were recorded and coded only once before being put into machine-sensible form.

Benefits

The final report included 115 separate recommendations for a total cost reduction of $213,000 per year. Although this saving is quite impressive, the major, long-term benefit from the study was the realignment of functions, which to a considerable extent eliminated duplication of effort and the source of some internal friction.

Case No. 18 — A Decision Table Matrix for Simpler Processing of Customer Complaints, Resulting in a Large Staff Reduction and Vastly Improved Customer Service

The Problem

After achieving a 40-per cent reduction in costs through methods improvements and across-the-board cuts, a large pub-

lisher wished to make further reductions in its claims-adjustment department, which processed an average of 4,000 to 5,000 customer inquiries and complaints per day.

The Approach

A specialist in paper work systems and clerical work simplification from the accounting firm's management services department was assigned to work with the supervisor of the claims adjustment department over a period of several months. Together they defined how each type of complaint and its many variations was handled under existing procedures. They then carefully analyzed each step with a view to eliminating unnecessary steps and simplifying the rest, following a general policy of (1) satisfying the customer as quickly and simply as possible, and (2) accepting the customer's statement of fact without extensive investigation whenever the cost of investigation was likely to exceed the cost of acting without investigation.

What Was Done

This approach led to the conclusion that complaint handling procedures could be simplified to a remarkable degree. The next step was to describe the new simplified procedures in a simple, concise form that could be easily used and understood by a large number of relatively unskilled clerks. After some experimentation, decision tables were adopted as the most suitable form. The staff of the accounting firm developed a six-page set of decision tables to simplify and condense clerical rules and procedures formerly contained in a manual of several hundred pages. The new tables link problems and actions by means of a matrix and indicate at a glance what actions are to be taken for each type of complaint under each possible combination of facts and circumstances. Training sessions were held to instruct the clerks in the new procedures, and conversion was effected within a period of ten days. Arrangements were made to transfer excess staff to other departments soon after the new procedures were adopted.

Benefits

The number of file look-ups was reduced by two thirds, and the number of dictated and typed replies by about 50 per cent. Sixty people are now able to process the work that formerly

required a staff of 100, and training time was reduced from many months to several weeks. Customer service was vastly improved because the department's processing delay was reduced by 80 per cent.

WHAT THE ACCOUNTING FIRM SHOULD NOT DO

The kinds of work that the management services department of a C.P.A. firm should not attempt to perform fall into two groups:

1. Those that the C.P.A. firm is not equipped to perform, and
2. Those that, if attempted and if the client is also an audit client, would prevent the firm from taking an independent and objective position toward the client in the firm's capacity as independent auditors.

Among the types of work the C.P.A. is not equipped to perform are detailed appraisals of buildings, machinery, and equipment; determination of chemical or physical composition of products; and similar work involving specialized technical knowledge.

The second type of services, those that would prevent the firm from taking an objective or independent position vis-à-vis the client, involves making management decisions for the client, taking responsibility for a basic course of action or policy, or taking part in management operations.

Obviously no one, be he accountant, lawyer, or engineer, who is responsible for a management decision or policy can be independent or objective about it. He is committed to it; he must make it work and defend it.

3

The Financial Executive and Taxation

IMPACT OF CORPORATE TAXES

Taxes the Price of Corporate Existence

Justice Oliver Wendell Holmes once said, "With taxes a man buys civilization—by no means a bad bargain." [1] For the corporation they are also the price of existence. Apart from Federal taxes and taxes on property, the corporation must pay state franchise taxes, sales taxes, and taxes on income levied by the states in which it does business. Not infrequently similar taxes are also levied by municipalities and other political subdivisions.

Since the total of all taxes paid by a corporation may often exceed its remaining net income, provision for compliance with the various statutes and regulations under which they are levied and the control and supervision directed towards making certain that the corporation pays no more than is legally required constitute one of the most important functions for which the financial executive is responsible.

Tax Obligations of the Corporation

The purpose of this chapter is to describe, briefly, the scope and the ramifications of the various requirements and obliga-

[1] Catherine Drinker Bowen, *Yankee from Olympus* (Boston: Little, Brown & Co., 1944), p. 407.

tions of the corporation in the field of Federal and state taxes and the tax help that may be derived from professional tax counsellors. Not every type of tax obligation will fall on every taxpayer, but some important obligations are common to all: withholding of taxes on wages and salaries, and reporting to employees and paying the withholdings to the Treasury; reporting payments, such as interest, where withholding is not required; and filing returns and paying Federal and state income and franchise taxes. Often, even in small business, collecting and remitting excise and sales taxes is also mandatory.

Tax work may be done by employees of the corporation, independent accountants, or legal counsel, but it must be done. The very small business may leave practically all of the work to the accountant, who may also write up the books. Here it is unlikely that a lawyer will be consulted. In any business large enough to employ a full-time bookkeeper or accountant, some of the tax work will be done by employees, particularly that related to wages and salaries. It is evident, however, that the larger the business, the less the detail tax work to be done by the independent accountant and the more consultation and guidance needed from both accountant and legal counsel.

The Tax Department of a Large Corporation

Perhaps the clearest way to describe the situation is to take the most complex situation as an example. After examining the requirements for a large and complex enterprise the financial executive, or any other executive for that matter, can easily decide what functions of tax planning or administration do not apply to his organization. He will get a better picture in this way than by adding to or amplifying a description of a simple and uncomplicated situation to make it cover, say, a large and diversified enterprise operating internationally.

A large operating-holding company, with foreign and domestic subsidiaries, doing business in several states and foreign countries and engaged in the production of raw materials as well as manufactured products, would require about as many, and as varied, tax services as would ever be needed. Typically, such an enterprise would have a tax department of its own, headed up by an experienced tax accountant, who would gen-

erally report directly to the controller or other chief financial officer. He would, of course, have an adequate staff, often including a tax lawyer employed by the corporation.

The independent certified public accountants of the enterprise and its legal counsel would be available for advice and consultation. When new conditions arose or when new tax policies were being formulated they would be adopted with the approval and concurrence of accounting and legal advisors.

The work of the tax department, while it should never become routine, would be divided between usual and recurring functions (such as making necessary provisions for compliance with the requirements of the taxing authorities and preparing returns in situations where there are no new or unusual situations to be dealt with) and those situations where new or unusual problems arise, through either action or contemplated action of the corporation or action of the Internal Revenue Service in questioning or disputing actions or conclusions of the corporation.

Compliance with Government Requirements

Government, particularly the Federal government, requires the corporation to act as a tax-gatherer. Taxes must be withheld from wages and salaries and accounted for and paid to the Treasury Department. Sales and excise taxes, both Federal and state, must be collected and paid to the different taxing authorities. In some industries—for example petroleum, tobacco, and distilled liquors—the payments for excise or sales taxes are among the largest or may even be the largest disbursements the enterprise makes.

Although the government requires the enterprise to act as a tax-gatherer, it pays none of the cost of collection of the taxes or of the required dissemination of information to employees and others, except for allowing the expense as a deduction from taxable income. Here the independent accounting firm, particularly its management advisory services department, can render most valuable service.

The organization of the vast amount of detail necessary to calculate income tax withholdings and to give individual employees the required information, as to both income tax and

social security and of the detail required to be assembled and reported for sales and excise taxes, is a field where important savings can be made by the best use of the appropriate electronic and mechanical equipment. The independent public accounting firm is well fitted both to devise the systems for meeting the requirements and to advise on the equipment best suited to the operation.

The tax department of a national or international enterprise, in addition to its responsibilities for Federal income taxes, must also see that all requirements are met in the fields of state franchise taxes (whether based on income or not), excise taxes, and state withholding requirements for individuals.

Foreign Taxes

If operations extend to foreign countries, income taxes levied by those countries, while generally the primary responsibility of the tax department of the parent company, are frequently also the responsibility of legal counsel and of the independent certified public accountant's branches or correspondents in those countries.

TAXABLE INCOME VS. BUSINESS INCOME

Defining Taxable Income

The Federal government exercises a minute supervision, or has the authority to do so, over the accounts and financial affairs of the taxpayer. In some instances it determines the amounts of dividends that must be paid and limits the deductible salaries of officers and other employees. It sets the limits of depreciation deductions and passes on the propriety of inventory methods. It determines when, for tax purposes, income is to be taken into account and when expenses are to be deducted. The government does all these things and many more for one purpose of its own: the determination of taxable income.

Taxable income is based on and may be reconciled with the business income of an enterprise, whether corporate, partnership, or individual, but there are frequently substantial differences because the two concepts of income are different in

important respects. Business accounting has for one of its purposes the determination of the income of the enterprise based on the matching of revenues and the appropriate costs or expenses and for another the presentation of information in the form most useful to owners and management.

In determining taxable income the government is concerned with neither of these things. Taxable income, while based on business income, is the creature of an incredibly complex and voluminous collection of statutes, regulations, court decisions, rulings of the Internal Revenue Service, and Revenue Procedures. To some extent day-to-day practice of Treasury agents is an unofficial but important part of tax administration.

These various sources of authority have widely varying weights. Court decisions, solidified into years of practice, are probably the most nearly permanent. Statutes can, of course, be amended, and they frequently are. Regulations, sometimes going beyond the statutes, are the joint product of the Internal Revenue Service and the Treasury. They can be adopted or changed only after hearings and are dependent on the statute they interpret. Revenue rulings issued to the public are followed until altered or rescinded. Private rulings, for particular cases, are neither made public nor are they necessarily followed in similar cases. Revenue Procedures, such as that establishing guideline depreciation in 1962, may be adopted or rescinded at any time without notice or hearings. There is considerable variation in practice in different districts at the agent level, although the Washington office is constantly trying to correct this.

Evolution of Tax Accounting

From the time of the adoption of the Sixteenth Amendment it has been the ostensible purpose of the Treasury Department to assess the corporate income tax on the basis of corporate income arrived at under generally accepted accounting principles and practices.[2]

In most respects this is still true, but it has seemed neces-

[2] Article 22 of Regulation 45 under the Revenue Act of 1918 stated: "If the method of accounting regularly employed by him (the taxpayer) in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for."

sary, in some cases, to adopt methods and practices that are at variance with accepted accounting practices. In some instances, these have been designed to prevent injustices to some taxpayers or to encourage certain activities and operations thought to be in the national interest.

The treatment of certain accruals and the timing of the realization of income are among the principal differences in method between corporate and tax accounting. The time when income is received is the Treasury criterion for inclusion in taxable income rather than the time when the matching of income against the appropriate expense is possible. This is sometimes called the "claim of right" or "bird-in-hand" method. While it has no accounting basis it is sometimes said to be necessary for administrative purposes.

Accruals of costs and expenses unpaid for which no liability to a third party exists at the time of the charge to income—for example, reserves for certain types of repairs, real estate taxes, severance pay and other fringe benefits, and other reserves for similar costs and expenses—are, for corporate purposes, normally charged to income as the reserves are created. Under the Revenue Code of 1954, reserves of this type were deductible for tax purposes, but the provision was later repealed.[3]

Special provisions affecting taxable income having no relation to corporate income, such as five-year amortization of facilities acquired under certificates of necessity in the Second World War and the Korean conflict and percentage depletion allowed members of the extractive industries, also bring about differences between corporate and taxable income.

Effect of Taxation on Corporate Accounting

These features of the corporate income tax have had a considerable effect on corporate accounting. With some corporate managements there is a tendency to attempt to make corpo-

[3] Section 452 of the Internal Revenue Code permitted the taxpayer to defer the reporting of prepaid income. Section 462 permitted the taxpayer to elect to accelerate the deduction of certain estimated future expenses by deducting additions to reserves for those expenses. The original estimates made in 1954 of the loss in tax revenue from the application of sections 452 and 462 was $45 million for the fiscal year 1955. Revised estimates indicated that the tax revenue loss might be as great as $1 billion or more. It also appeared that the sections were being interpreted by taxpayers as extending beyond the scope intended by the Treasury Department. These facts led to their repeal.

rate income conform to taxable income as closely as possible, largely for convenience.

One school of thought holds that, under the general principle of matching costs and income, the income tax in a corporate income account should be the tax that applies to that income, regardless of whether it was the tax paid in the period. This has necessitated the use of the "tax deferral method" whereby the amount of tax based on the corporate income is shown in the financial statements and the difference between this and the actual payment is deferred to the period to which it applies. An example is five-year amortization under certificates of necessity where, in the years affected, tax on the difference between the amortization and normal depreciation would be added to the tax paid for the year just ended and deducted from the tax paid in subsequent years.

The mere fact that there is a difference between taxable and corporate income does not mean that tax deferral accounting is necessarily required. Mining companies or petroleum producers will, because of percentage depletion, show less taxable income than corporate income but, as this is a continuing situation, no adjustment is required.

Long-Range Character of Tax Planning

It must be remembered that we have had income taxes with us for some fifty-three years, and there is probably no one now alive who will see their end. Tax planning is, therefore, a major long-range business function. It is also true that most methods devised for the reduction of taxable income, as distinguished from the tax to be paid, do little beyond changing the time when income must be taken into account. The total income of a corporation from its inception to its liquidation will be substantially the same under any consistent method. This does not mean that timing is not of great importance.

One of the most important aspects of timing is the full utilization of carrybacks and carryforwards of operating losses. The means for doing this are fully explained in statutes, regulations, and numerous texts, but a high degree of alertness is necessary to see that transactions are timed and planned in the most advantageous way. While the total income over a

period will not be changed, the failure to use a carryback or carryforward of losses may seriously affect the total tax paid.

Cash flow, on which so much corporate action depends, is also directly affected. Tax rates vary from year to year so that, over a long period, total tax paid may be quite different under different circumstances. For example, taxpayers in 1934 were outraged when their depreciation allowances were reduced under Treasury Decision 4422, but they lived to see the deductions, disallowed in 1934, allowed in periods of higher rates and even against excess-profits taxes.

Tax planning is a long-term affair, and apparent immediate advantages should be weighed carefully against future possibilities. One of the most annoying things a tax advisor has to put up with is what might be called the locker-room tax expert. A client calls, usually on a Monday morning, and says, "There's a big company in our line that gets twice as much deduction for bad debts as we do and the president takes his whole family to Europe twice a year on his expense account. Why can't we do the same thing?" When the accountant asks for the source of the information it turns out to be the nineteenth hole at the client's golf club and a long time is spent in disabusing the client of his illusions.

While both accountant and client should be alert to any real tax advantages, any method of quick or drastic tax reduction should be carefully analyzed and its future as well as immediate effects estimated. The regular auditors and tax advisors of a corporation expect to serve their clients for a long time. They are more interested in a consistently good tax position than in any short-term spectacular reduction that may bring about undesirable future effects or conditions.

TAX ADVISORS AND THE FINANCIAL EXECUTIVE

Need for Counsel

As every businessman knows, the role of taxation is large and important in the economy. Its complications and difficulties are tremendous. The function and duties of the executive preclude any possibility of a technical knowledge of the

detailed workings of the various taxing systems to which his corporation is subject. He must, instead, take a broad view of the whole picture.

He is responsible for the strategy, the policy decisions. He must rely on his accounting and legal advisors for the detail, the technical work, the tactical operations. His protection and his assurance of the best results for the corporation depend on his choice of the best accounting and legal advisors, and one purpose of this chapter is to furnish a few guides for making such a choice.

As previously explained, many corporations have their own tax departments, which make out the necessary Federal, state, municipal, and other tax returns for the corporation and keep themselves informed in the areas of taxation that affect the corporation in its ordinary operations. Other corporations rely completely on their accounting and legal counsel for tax advice. Whether the organization of a tax department is indicated or whether it seems better to rely entirely on professional advice, the review of tax returns, first by the independent C.P.A. and then, if there are any new or debatable questions, by legal counsel, is essential for the protection of both stockholders and officers.

Whether all the complications and verbosity of the various sources of taxing authority are necessary is an open question, as is the related question of discrimination against the smaller taxpayer who cannot or does not receive adequate tax advice; but the fact of the proliferation and complexity of the taxing statutes and their interpretations remains to be dealt with.

Many changes in the statutes and regulations have been made ostensibly to simplify the laws and procedures, to introduce more equity into the administration of the tax laws, and to ameliorate the harshness of some of the provisions of the statute. The objectives of amelioration and greater equity have, to some extent, been attained, but every change has introduced new complications and swelled the volume of the official sources of the operation of the Federal income tax.

Since the accounting for taxable income follows but does not necessarily coincide with the company's own accounting methods, it is necessary to examine every difference and variation with the utmost care, first, to be sure that the method

used is authorized, and second, that no relief provision or allowance has been passed over.

The Lawyer and Accountant in Tax Practice

There has been much rather pointless discussion of the roles of the lawyer and the accountant in tax matters. Generally speaking, the accountant, employed or independent, prepares the returns. This is logical, since an income tax return is merely another form of financial statement. This is particularly true for the corporation return, which includes a balance sheet and a reconciliation of surplus between the tax and the corporate basis. The preparation of a tax return is not legal work, no matter who does it. As in the preparation of any other financial statements legal questions will frequently arise. The accountant should be able to recognize them and should know when to request the advice of legal counsel.

It often happens that the corporation wishes to take some specific and unusual action: purchase or sale of another enterprise, participation in a joint venture, issue or retirement of securities, changes in capital structure, and the like. The accountant should be consulted on the probable results of such action, but before any definite steps are taken legal counsel should be called in to make sure, first, that the proposal can be carried out, and second, that it is done in such a way as to have no undesirable tax or legal side effects.

The function of the accountant is to give management information on what can be done and the probable results; that of the lawyer is to say how it should be carried out. As a practical matter the accountant and lawyer work as a team, and there is seldom any difficulty about their working together satisfactorily.

As an example of this, a certified public accountant may represent his client before the Tax Court in the same way a qualified member of the bar does. At first this was hailed as a great advance for the accounting profession, but it soon became evident that the mere permission to act like a lawyer did not make the accountant one. In the Tax Court, as in any other court, the accountant best serves the interests of the client by briefing the lawyer on the accounting principles and

methods involved, assisting him in formulating policy and strategy, and testifying to facts and accounting principles.

Where the accountant had also had thorough legal training he was occasionally able to represent his client as a lawyer would, but such cases have been comparatively infrequent. Most accountants realize that it is undesirable to represent clients as an advocate before the Tax Court.

The old saying that the man who acts as his own lawyer has a fool for a client is particularly apt in tax matters. Not only is it impossible for an executive with other responsibilities to make technical tax decisions or recommendations without advice, but the field of taxation is so broad and so full of hidden quagmires and quicksands that it is most unusual for any one partner of an accounting firm to claim a detailed and expert knowledge of the entire field.

TAX SERVICES OF C.P.A.'s

The specific work of an accounting firm's tax department or of the tax accountant and tax lawyer, while it can hardly be reduced to a comprehensive checklist, can be described under a few general headings that will include all but the more unusual situations.

Preparation and Review of Returns

In the large corporation, and in many smaller ones, it will be the duty of the internal tax department to prepare the returns, which will be reviewed by the independent accountant both for tax features and to satisfy himself that an adequate provision for the tax liability has been made. Legal counsel will be consulted if the return is a large one or it presents any unusual features. In the smaller corporation the independent accountant may prepare the return from company records. In any event, it should be reviewed by him.

Regardless of who prepares the return, the C.P.A. will be primarily concerned with making sure that the statute and regulations have been properly complied with, reducing the possibility of unnecessary audits, and taking advantage of all beneficial provisions for the computation of taxable income.

Tax Planning of Corporate Transactions

Where transactions are initiated or contemplated by corporate officials the independent accountant can, frequently in consultation with legal counsel, make estimates as to not only their immediate effect but also their impact on the tax position in the future. He can also evaluate the possible effects of alternative methods of handling the same transaction and suggest changes in its form and substance toward a legitimate tax advantage.

The prudent financial executive will not enter into any transaction or operation affecting income taxes without consulting his legal and accounting advisors. It should also be remembered that the time for consultation is before anything is done, not after.

Business Purpose. In many transactions where a tax saving or advantage exists there may be a presumption on the part of the Internal Revenue Service that the tax saving was the prime or, perhaps, only motive for entering into it. In these cases it is necessary for the taxpayer to demonstrate that there was a business purpose that was the principal reason for the transaction and that the tax effect was secondary and subsidiary to the business purpose.

The independent accountant is qualified to testify on the subject of business purpose. It is sometimes advisable to get the testimony on this point of an independent accountant who is not the auditor of the corporation.

Appearances Before Taxing Authorities and Courts

In Federal taxation it is customary for the independent accountant to represent the taxpayer when a dispute or difference of opinion arises between the Revenue Agent and the taxpayer. Generally the first meetings with the agent are attended by the accountant and taxpayer only in the hope of arriving at a quick and informal settlement. This should cause no embarrassment later to the tax attorney, as the conferences with agents and group chiefs are not matters of legal record.

If the taxpayer is unsuccessful and the tax is of any large

amount, or if the case may be used as a precedent in future years, it will be taken to the Appellate Division of the district. Here it is almost always advisable to have the advice of the tax attorney, since the case may go to the Tax Court or to some other Federal court. The accountant generally collaborates with the tax attorney in preparing appeals to the Appellate Division.

The Accountant as a Witness in Tax Cases. The accountant frequently appears as a witness in the Tax Court or other courts, sometimes representing the client and testifying as to the facts in a given situation and sometimes testifying for a party not otherwise a client on the application of accounting principles or trade practices in an industry with which the accountant is familiar. Accounting testimony before the Tax Court, the Court of Claims, or other Federal courts is frequently the determining factor in the decision. Occasionally, as in cases of alleged fraud, the accounting testimony may serve to clear the client. In one case where the method of determining income was clearly not that required by the statute and fraud was alleged, the accounting testimony established that the method employed, although not that required by statute, was one that could have been employed, as the taxpayer contended, as the result of an honest mistake. Additional tax and interest was assessed but no fraud penalties were imposed.

Practically all personal contact of the accountant with the Internal Revenue Service is a type of forensic representation and one of the most important. The financial executive and his assistant in charge of tax matters should be in close touch with this work from the beginning.

Services of Specialists

Federal income taxation is so closely connected with business operations that many accountants have specialized in particular aspects of business operations as they affect taxation. For example, it is not unusual in both regional and national firms for one partner to be a specialist in the treatment of inventories for tax purposes. The methods of large retailers and processing industries have a great influence on income

determination, cash flow, and the retention of working capital. Another partner may specialize in the extractive industries, with special emphasis on problems of depletion and the treatment of development and exploration expenses.

Mergers and acquisitions present many problems, particularly in the choice of the methods of sale or liquidation. Substantial tax penalties might be incurred if matters of form and method, as opposed to substance, are not properly taken care of. This requires accounting advice on objectives and probable results and legal advice on the precise methods of sale and liquidation.

Questions of depreciation have become both important and complex over the years. Periodic review of useful lives and depreciation methods, as well as of property accounting, perhaps in conjunction with appraisers, is necessary to ensure that every possible advantage is being taken of any changes in regulations or permitted methods of depreciation or to make certain that there is a proper groundwork of evidence if the lives or methods being used are questioned.

There are many other areas where advice is sometimes needed. The executive and the head of his tax department should be constantly on the alert for situations in which accounting and legal advice is required before making decisions or entering into large or unusual transactions.

Advice on Proposed Legislation. Valuable advice on organizational set-up or method of handling a transaction can be offered by the accountant when new legislation is pending. An example would be advance planning for Subchapter F affecting United States recognition of income of foreign subsidiaries.

In the past, accountants have taken an active part in advising Congress and the Treasury Department on legislation covering the last-in/first-out inventory method, depletion of natural resources, and depreciation methods, to name only a few examples. The reliance of Congress and the Treasury on the advice of accountants appears to be increasing as more and more complex problems arise.

Aid in Organizing Client's Tax Department. For newly formed enterprises the independent accountant can develop an

organization plan for the department and usually can assist in obtaining the necessary personnel. Where the corporation has a tax department already established, periodic review by the independent accountant will frequently bring to light possibilities for improvements and economies.

ESTATE PLANNING AND PERSONAL INCOME TAXES. The accountant should be a member of the team, along with attorneys and insurance advisors, when questions of estate planning arise. The estate planning of corporate officers is sometimes closely connected with corporate affairs, and this is often considered a responsibility of the financial executive.

Some accountants specialize in personal income taxes and inheritance taxes, and most well-organized firms have partners skilled in these fields. Any executor or trustee needs the best accounting advice he can get, combined of course with appropriate legal advice. Legitimate methods of minimizing these taxes exist and require the same alertness and care that is needed for the protection of the corporation.

4

Getting the Most from the Independent Audit

ANNUAL AUDIT AND CERTIFICATION

Auditing Standards

The financial executive who has not himself had practical auditing experience seldom realizes that any audit, whether by independent C.P.A.'s or by internal auditors, is to some extent a compromise and an approximation.

An audit in complete detail, where every transaction and entry is fully verified, should uncover all chance or inadvertent errors. Intentional errors involving over- or under-footings of a cashbook, the abstraction of cash and substitution of false entries for credits or allowances for cash receipts, various types of payroll and inventory frauds, and the like, would in all probability be discovered.

But even an audit of this type would not uncover frauds where the false entries were substantiated by documents forged skilfully enough to deceive other company officials as well as the auditors, which has happened several times in the recent past and may be tried again.

In any event a complete, detailed audit, which would mean in effect that the original work on the records would have to be done over by higher-paid personnel, is impractical and prohibitively expensive.

At the opposite pole from the detailed audit is an examination made by a highly qualified auditor whose only criterion for the verification work he should do is whether it is sufficient to satisfy him of the substantial correctness of the statements he is examining.

Ideally and philosophically this is the basic principle underlying all auditing, but not all audit work is performed by highly skilled men of impeccable judgment. Much of it is necessarily done by junior and lesser-experienced employees of the independent C.P.A. or by junior members of the internal audit staff. This fact and the necessity for a continuity of procedure makes certain auditing procedures and the extent to which they are applied practically mandatory.

The procedures, however, are always changing in nature or emphasis. The auditor suffers under the disadvantage of having the general outlines of his work, the consensus on what ought to be dealt with, and what emphasized and what played down, known generally to those whose work he is examining or criticizing. The ingenuity of the potential defaulter or embezzler is constantly being pitted against the skill of the auditor, always to the disadvantage of the latter. This applies, at the present time, more to the internal auditor than to the independent C.P.A. The internal auditor is usually responsible for the detail checking and the independent C.P.A. for a methods review and survey.

When a fraud of any importance is discovered, the independent C.P.A. should inquire, first, whether prescribed procedures had been followed by the internal auditors, and second, whether some revision of the internal control system is indicated. Minor frauds and defalcations, not significant in amount, may be important as indications of weaknesses in design or operation of the system of internal check and control.

Development of Internal Control and Analytical Auditing. In earlier days, before internal auditing and internal control were developed and when a lower salary scale permitted it, so-called "detailed" audits were made by professional accountants in which almost every transaction was checked and almost every clerical operation was tested and

scrutinized. As industrial enterprises grew in size and complexity it became evident that this type of auditing, sometimes irreverently known as the "tick and holler" method, was not only becoming prohibitively expensive but was not fully effective.

About the time of the First World War, industrial enterprises, large and small, began to develop internal control systems and to employ internal audit staffs. These developments were welcomed by the accounting profession, and professional accountants played a large part in organizing internal control systems and in the organization and training of internal audit staffs.

Analytical auditing, that is, a test of the accuracy of the accounts by comparing total production, total sales, process or manufacturing losses, gross profits, and similar quantitative key figures, was developed. The functions and responsibilities of the internal auditor and the public accountant were defined and delimited, not always with the precision and exactness that might be desired.

It was difficult for an executive, accustomed for many years to a detailed audit by his C.P.A. firm, to reconcile himself to the fact that he could no longer hold the C.P.A. responsible for a minor fraud undiscovered either by the internal auditor or the C.P.A. On the other hand, there were cases where too great reliance was placed by the independent auditor on internal auditing and internal control. Procedures formerly thought necessary, or at least desirable, were no longer carried out.

The confirmation of accounts receivable or payable by direct communication with the debtor or creditor, while not an invariable procedure, was not uncommon up to, say, the beginning of the First World War. From that time until 1939, about the only audits in which this procedure continued to be used were the audits of stock exchange firms and some financial institutions.

In the early days, physical tests of inventories were often made, particularly when the purchase or sale of a business was involved. This practice fell into disuse in the era between the First World War and 1939, and it was considered that a satis-

factory verification of the quantities reported in inventory could be made entirely from the records without physical tests by the auditors.

Independent verification of cash in banks, actual count of securities or confirmation by independent third-party custodians, and verification of both approval by the board of directors and vouching of expenditures for capital assets were considered essential to an audit from the earliest days.

Revision of Auditing Standards. Several instances of the deception of auditors and company officials as well by other company officials about the existence and value of company property, largely through the preparation and use of forged documents—letters, invoices, orders, cash statements from nonexistent banks, warehouse reports from fictitious warehouses, and forged reports from credit agencies—caused the accounting profession, through the agency of the American Institute of Certified Public Accountants and the various state societies, to undertake an extensive reexamination of auditing standards and practices.

As a result, it was decided (1) that the auditing standards of the time were inadequate and had to be revised, and (2) that the firms of accountants involved in these frauds had adhered to the standards then current, and could not be held to have committed any act discreditable to the profession, and had violated no provisions of the code of professional ethics of the American Institute of Certified Public Accountants or the various state societies.

The auditing procedure committee of the American Institute of Accountants; as the A.I.C.P.A. was then known, in October 1939 issued its Statement No. 1, which in effect stated that from that time on accepted auditing standards and procedures required the auditor to make tests of inventories by physical inspection and to test accounts receivable by direct communication with the debtors.

It was made clear that the auditor was not acting as an appraiser or valuer but was, instead, "satisfying himself as to the credibility of the representations of management regarding quantity and condition" of the inventory. These basic

auditing standards, as revised in 1939, have met the practical requirements of the business and financial community remarkably well. Despite the passage of time they are as applicable today as when they were drafted. (See Appendix C, Statement on Auditing Procedure, by the Committee on Auditing Procedure of the (then) American Institute of Accountants.)

The independent confirmation of notes and accounts receivable was also required by Statement No. 1 (Appendix C) of the Committee on Auditing Procedure, but the auditor was allowed a considerable degree of discretion in determining when and to what extent such confirmations should be made.

The requirement for the general application of these procedures was, as has already been indicated, a revival of past practices rather than the development of any new or experimental methods.

Auditing and the Computer. Up until a few years ago it was thought that the 1939 revisions in auditing practices and methods would make any further basic changes unnecessary for a long time to come. The introduction of computers has changed all that. The dishonest company officer who wishes to distort a company's position or results and the potential defaulter or embezzler are still with us. They will study the computer and the other electronic devices now in use and will try to find a way to misuse these instruments for the same purposes as were formerly accomplished by forgeries and false entries.

Methods are being developed for the audit of records based on the work of computers. Wonderful as they are, computers are only machines. They can act under instructions; they can remember; they can answer questions, if they have the answer; and they can say yes or no to a question if they have the information stored in their memories. All these things they can do, generally more accurately than a human brain, but they cannot use judgment or make a real choice or decision. Their apparent decisions are merely comparisons of given sorts of information already fed into them, and their so-called choices are also based on comparisons and compilations of data already in their program or memory.

These are not robots[1] about to come to life and take over from human beings neither as strong nor as intelligent as themselves. Complicated and forbidding as they may appear, computers are and always will be subservient to human beings far inferior to them in mathematical skill or even in the playing of chess or checkers. They must be guided and instructed minutely in everything they do, and it is precisely this feature that makes them subject to audit and control.

The audit of the results of the work of computers is essentially a matter of survey and review rather than of any checking or testing of detail. An examination of the programs covering the operation of a computer and some assurance that the program shown to the auditor is actually the one that is used is one of the best verifications of its work that the auditor can get.

Once the machine is programmed and the information fed in, the mechanical accuracy of the result generally is not subject to further detail checking, except for what is needed to show that the system is in fact operating. Analytical auditing, the comparison of total results of various operations and functions, is one of the most effective ways of auditing a computer's work.

Errors made by computers are infrequent, but fortunately when the computer goes wrong it generally does it in a big way. An error in payroll where a check is issued for $1,000,195.47 instead of $195.47 is much more likely to be caught than if the erroneous figure has been, say, $145.47. Any sort of comparison of totals would catch the first error, while the second might go undetected. Fortunately, the probability of any mechanical error is small and, with the improvements in electronic "hardware," grows less and less.

The financial executive, and the auditor as well, should remember that the work of computers can and should be audited, that what comes out is only as good as what goes in, and that, regardless of mechanical capabilities, the real decisions and choices are made by people. The work of the computers gives

[1] Mechanical men in a play, *R.U.R.*, by the Czech dramatist, Karel Čapek. Some of their abilities and characteristics had a remarkable similarity to those of computers, and the play, written in 1921, is an amazing exercise in constructive imagination.

a better basis for these decisions and choices, but they are still made by human beings.

The Auditor's Opinion

THE CLEAN CERTIFICATE. Every executive, operating or financial, wants to see his financial statements go to stockholders, creditors, and the public with what has become generally known as a "clean certificate" attached to them.

While the importance of a clean certificate can be overemphasized, it is nevertheless true that its presence shows that there are no major differences of opinion between client and auditor and that the auditor has carried out every procedure he thought necessary to satisfy himself that the statements fairly present the financial position of the company and are not, in the language of the Securities and Exchange Commission, "misleading." The clean certificate further states that, in the opinion of the auditor, the statements are prepared in accordance with generally accepted accounting principles and that they are on a consistent basis from year to year.

Naturally, if these conditions are not all present, a clean certificate cannot be given and some exception must be taken or some explanation made.

THE QUALIFIED CERTIFICATE. Not everything that requires an explanation or exception is necessarily damaging or discreditable. Most of what we might call the harmless exceptions are on the score of consistency and often cover desirable changes in accounting methods or changes made to recognize changed conditions. These are frequently the change from one to another accepted method—for example, from or to the installment method of accounting for sales; the adoption of the LIFO inventory method; deferring rather than expensing development and exploration costs; or, in the case of a plant where a new process is involved, deferring initial or "starting up" expenses although similar expenses were written off in the past when they were not large enough to distort the income materially.

In such cases the auditor, if the effect of the change is material, must recognize it in his certificate but will make no ad-

verse comment and will generally include the words "of which we approve." Such exceptions or explanations should cause no concern to the financial executive or to anyone else.

If, however, there is a genuine difference of opinion between the client and the auditor, and the auditor decides that the statements, as prepared by the client, do not fairly present the financial position of the company, he must also decide whether they make a fair presentation when read in conjunction with the exception taken in his certificate.

For example, if the auditor has reason to believe that some contingency, such as probable damages resulting from an unfavorable decision in a lawsuit, is so serious as to make the statements misleading if it is not mentioned, mention in the certificate might be enough to make the statements, read in the light of the certificate, a fair presentation.

When No Opinion Can Be Given. Broadly speaking, there are two situations in which the auditor cannot give an opinion, qualified or otherwise. The first is where the financial statements are so prepared as to be materially misleading and this cannot be corrected by an exception taken by the auditor. In the second, some required audit procedure is omitted, making the auditor so uncertain about the integrity of the accounts that he cannot form an opinion as to the fairness of the presentation.

The first condition might result from the inclusion as an asset of a substantial amount of research and development expense on a product or process of little or at best highly doubtful value. The auditor cannot put a value on the expenditures, but he knows they are material and their value overstated.

Another instance would be the inclusion as current assets of accounts receivable from affiliates of doubtful solvency, which affiliates are not examined by the company's auditors. Here again, the amount, if material, would make the statements misleading, but the auditor has no way of determining the amount of any required adjustment.

Instances of this sort are infrequent. They sometimes occur when the auditor is representing some parties other than the client company itself: creditors, minority stockholders, preferred stockholders, debenture holders, or others whose claims

would be jeopardized by the management's course of action in issuing and attempting to justify the misleading statements.

The second type of situation, the omission of some required audit procedure, is much more frequently met with, although this situation is improving and partial audits are tolerated much less frequently than in the past.

The financial executive of a substantial corporation, large or small, will seldom encounter this problem in his own company. If, for any reason, his company must report to the Securities and Exchange Commission under any of the various Acts under which the Commission operates, an audit leading to a certificate without adverse qualifications is a necessity. Even if it is a closely held corporation where the stockholders are all personally acquainted with each other there will generally be a demand for an audit permitting the auditor to give an opinion on the financial statements.

The partial or incomplete audit is most frequently met with in the small, one-man corporation, the individual proprietorship, or the small partnership. Here the owner or proprietor is convinced that he knows everything about his business and does not need an audit leading to an opinion on his financial statements but merely requires, say, an audit of cash transactions.

Banks and other lenders have, more in the past than at present, condoned the omission of required audit procedures and accepted uncertified statements as a basis for credit. In these small enterprises the bank is frequently the only third party that ever sees the statements, and even here the practice of submitting "no opinion" reports is becoming less and less frequent.

The answers to the questionnaire on this point bear out these conclusions (Appendix A, pp. 178–180).

About the only situation where the "no opinion" or unaudited statement would affect the financial executive of a substantial corporation would be in deciding what policy to adopt when such statements are offered by a customer to support his request for a line of credit. In most cases the submission of an unaudited or "no opinion" statement would not be sufficient reason for an unqualified refusal to grant any credit. It should, however, be pointed out to the customer

that the submission of a certified statement would make it much easier for the credit manager to extend the line of credit to which the customer thinks himself entitled.

It is sometimes obligatory, instead of refusing to give an opinion, for the independent auditor to give an adverse opinion. In reporting to some party other than the company under audit, this may be required instead of a mere denial of the possibility of giving an opinion.

INTERNAL CONTROL AND AUDIT

Internal auditing of a limited type has been practiced in this country for many years. Before the First World War railway companies employed traveling auditors to check the operations of consolidated ticket offices, dining car operations, and other features of the transportation business. Enterprises with widely distributed operations in mining or manufacturing employed similar auditors. Their functions were generally limited to a cash audit including vouching of expenditures, testing of payrolls, and occasionally inventory tests. Management placed great reliance on their work, although the extensions of the functions and responsibility of internal auditors, so familiar now, were hardly thought of.

In the years after the First World War internal control generally and internal auditing in particular began a period of rapid development. The increasing volume and complexity of business operations made it necessary for management to devise some means, other than personal contact and inspection, that would enable executives to know how the different divisions of an enterprise were functioning and especially where there were any situations or conditions that needed correction and adjustment. This need was filled by the enlargement of the functions of the internal auditor and the raising of the level of ability and professional training of the internal audit staff.

A number of men of high caliber and vision, enthusiastic about putting internal auditing on a truly professional basis, joined the internal audit staffs of large corporations. Through their efforts, supported of course by the corporate managements, internal auditing was developed as a staff function without any operating duties or responsibilities.

This was necessary because objectivity was just as important to the internal auditor as to the external auditor. The internal auditor has become not only the eyes and ears of management, but also to a certain extent its representative in deciding what is a minor fault or infraction of a rule or policy to be corrected on the spot and what of enough significance to be reported to management.

The full recognition of the professional character of internal auditing may be said to have come about with the founding of the Institute of Internal Auditors in 1941. The high quality of the men who put internal auditing on a professional basis is shown historically by the large number of executives of large corporations—presidents, financial officers, and controllers—that have "graduated" from the internal audit staff.

Most large corporations are now so organized that internal control and internal audit are carried out by their own staff, although with some this came to be only in the last few decades. As we descend in the scale of size we find less and less in the way of internal auditing and control. Most accounting firms, large or small, require the accountant in charge of an audit to test the internal control procedures then in effect by answering an extended questionnaire on the subject and adapting his audit procedures to the results.

The Small Corporation

Small, closely held corporations frequently have little or no formal internal control. The management, often composed of the owners of the business, is in close touch with operations and relies on this rather than the usual methods of internal control.

The auditor, however, relies on such apparent safeguards at his peril. Familiarity with operations, personal acquaintance with employees, long experience in the trade or business, and conscientious attention to the details of the business on the part of management are not a complete or satisfactory substitute for effective internal control or, lacking that, an adequate independent audit.

The auditor is in danger in two ways: first, fraud or defalca-

tion by employees can, in such a situation, often go undetected for a long time, and second, if the company is in difficulties management can manipulate inventories, kite checks, suppress liabilities, and inflate assets in ways difficult to detect. Proper audit procedures will uncover these irregularities eventually, but the lack of internal control will delay this.

Results of Inadequate Internal Control

Examples of the results of inadequate internal control are not hard to come by, and most accountants of any length of experience could give many instances of the dangers of misrepresentation by owners and fraud by employees.

In a small real estate brokerage and management office, managed by a realtor of high standing and long experience, a substantial defalcation was made possible by the neglect of the most elementary requirement of internal control: one person was in complete charge of bank accounts and cash and also kept the firm books and prepared statements for managed properties.

Here the opportunity for fraud arose because the office collected rents from managed properties in the last few days of the month and remitted these to the owners, less janitor's wages, repairs, and the like, as well as management fees, about the end of the first week of the following month. There was, therefore, always a substantial balance in the firm's account at the end of the month because of the "float" represented by rent collections not yet remitted to the owners. The bookkeeper-cashier had at his disposal the part of the balance not due to owners and the management fees deducted on the owner's statements.

Management fees were credited to income but were taken by the defaulter. False financial statements showing a fictitious bank balance were submitted to the owner of the business, who took no steps to have the book balance of cash reconciled with the bank.

On the first day of the first audit a bank reconciliation was attempted and the bookkeeper-cashier confessed. If an indi-

vidual other than the cashier had reconciled the bank account each month or if the cashier had not had access to the financial books the fraud would have been impossible.

A type of fraud resulting from lack of internal control more difficult to detect was found in a small mining enterprise. The chief clerk was responsible for ordering materials and supplies, subject only to an engineer's approval. The company also operated a small townsite where it had constructed all the houses. The chief clerk in collusion with the storekeeper had him issue requisitions for building materials, plumbing fixtures, electrical equipment, and similar items, some of which—cement, lumber and some electrical supplies, for example—were purchased as mining supplies and some of which were similar to what was purchased for townsite repairs and additions. Items thus requisitioned were diverted to the construction of a house for the chief clerk in a neighboring town but were charged to various classifications of mine and townsite expenses.

The fraud was discovered when certain mining expense classifications and townsite repairs, apparently abnormal in amount, were analyzed. Proper supervision by operating officials, particularly of detailed operating costs and the ordering and issue of materials, would have detected the fraud.

The assumption by management of functions ordinarily the responsibility of subordinates is a definite danger signal. The distribution of functions among a number of individuals is the essence of internal control, and in some of the celebrated frauds of the century, for example, the principal executives of a company had taken personal charge of bank accounts or the issuing of purchase orders or invoices.

The writer, when a fraud of this type became public was asked by several clients, "Could this happen in our company?"

The answer was another question addressed to the presidents of the companies, "How many bank accounts do you control and reconcile personally each month and how many invoices and purchase orders do you prepare?"

The reply, of course, was, "We have a treasurer and controller to take care of the money and an order department and purchasing department to handle that part of the business."

In other words, an adequate system of internal control was

effective even so far as the principal executives of the company were concerned.

Supplementing Inadequate Internal Control

The devising of systems of internal control is a proper and useful function of the independent auditor. Where internal control is inadequate it must be supplemented by the independent auditor if a professional opinion is to be given.

If internal control is adequate, the responsibility of the independent auditor is to satisfy himself that the system is soundly based and is in fact in actual operation. It is usually necessary for the independent auditor to do some detailed checking and vouching and some testing of clerical work, but the more this can be reduced the better for both client and auditor.

REDUCING INDEPENDENT AUDIT COSTS

There is no way to reduce hourly rates on which independent accountants' fees are based. These are quite strictly controlled by the economics of the supply of and demand for qualified accounting personnel. The client can, however, in cooperation with the independent C.P.A., work out a program for preparation of schedules and confirmations, and all the other detail and clerical work that could as well be done by the client's staff as by that of the auditor, which will substantially reduce the audit work of the C.P.A. firm.

There is real economy in this, because this type of work can be done largely by clerical staff of the client somewhat below the professional level and compensated accordingly, whereas the staff of the auditor is composed almost entirely of professionally qualified personnel. The larger and better-organized companies will naturally be able to do more of this than the smaller client with a somewhat less qualified office staff, but even here much can be done.

Service Bureaus

Local and regional firms have worked out methods for their smaller clients to combine devices for producing perforated tapes with adding machines that are, in effect, books of original

entry. These are sent to a computer service bureau, and the necessary records, including ledger accounts, are printed out.

This is not only more economical than manual recording and posting, but it relieves the auditor of the expensive drudgery of so-called "write-up" work that has taken and still takes up so much of the time of the small local firm or the young accountant attempting to build up an individual practice.

It should be clearly understood that the function of the service bureau should be limited to the more or less mechanical bookkeeping and recording work. The client should not rely on the service bureau for advice on the form or content of financial statements or for advice on accounting principles or control methods as distinguished from the mechanical features of his accounting system.

An article in the *New York Certified Public Accountant*[2] is headnoted, "This is a 'how to' article on electronic data processing for local practitioners as well as large firms, combined with a realistic depiction of the consequences that will confront laggards." The advantages and opportunities of electronic data processing are well described, but the most significant point brought out is the possibility, and danger, that service bureaus and others offering electronic data processing service may also come to perform strictly professional functions, such as in system design and advising on the form and content of financial statements. It is a problem similar to that of the legal profession wherein banks and others offer services ordinarily performed by lawyers.

Working Paper Preparation

The auditor must have working papers sufficient to support his report and to indicate what he has done in the way of review and verification, what audit work has been done by the internal auditors, and the scope and effectiveness of the system of internal check and control. There is no reason why any part of the necessary working papers that does not have to do with testing or verification work actually carried out by

[2] John E. Lennox, "How CPAs Can Adapt to the Computer," *New York Certified Public Accountant,* December, 1965. See also Wayne S. Boutelle, "Auditing through the Computer," *Journal of Accountancy,* November, 1965.

the auditor (see pp. 93–98) cannot be prepared by employees of the client company.

It is the auditor's duty to satisfy himself of the accuracy of statements, lists, or schedules prepared by others, but this takes only a fraction of the time required for their preparation. Having such work done by the client's clerical employees is much more economical than having it done by the staff of the independent auditor.

What Audit Work Can Be Done by the Client

Most of the detail of the audit work, the checking, the preparation of supporting schedules and working papers, the preparation of accounts receivable confirmations, the preparation of inventory tags and lists, can be done just as well by the client's accounting staff or the internal auditors as by the employees of the accounting firm. Even such a difficult and complex operation as the preparation of a consolidated balance sheet and income account for an international enterprise is done by employees of the controller's department of the client.

The auditor's reliance on internal audit and internal control, where the functions are adequately performed, goes far beyond the matter of fraud. With an adequate inventory control system in effect, the physical testing of raw material and purchased inventories may be reduced to a minimum. A good standard cost system will make it possible to test work-in-progress and finished goods inventories, both for quantities and for pricing.

A corporation is likely to have good control of capital expenditures even though most other control elements are lacking, because the transactions are large, infrequent, and often the result of a policy decision.

There are various control devices for accounts receivable or payable, other liabilities, and changes in capital stock and fixed liabilities, all of which can be operated just as well by the staff of the clients as by the independent auditor, whose function will then be reduced to supervision and direction.

It must be stressed, however, that the professional functions that the independent accountant cannot delegate to anyone not a member of his firm or in his employ are those of *review* and

evaluation leading to the expression of an informed professional opinion on financial statements and other accounting, financial, and administrative matters.

At the end of this chapter is a program for the audit and internal control of a medium-sized manufacturing enterprise, showing the work that must be covered for a satisfactory verification of the financial position. The items of the program are then classified according to the work to be performed by the independent auditor and no one else, and the work that may properly be carried out by the client's employees or the staff of the independent auditor, whichever appears most convenient. The program is designed for application to an accounting system based on written records, although it is assumed that all appropriate mechanical accounting and recording devices are used.

It is assumed that the independent auditor will review and scrutinize the verification and investigative work of the staff of the client in much the same way as a senior accountant would review the work of his assistants. The division of work between the independent auditor and the staff of the client is not intended to be taken as a rigid and definite pronouncement but rather as an indication of, first, the type of work that must be done by someone if a satisfactory audit foundation for an unqualified professional opinion is to be laid, and second, the type of work that cannot be delegated to anyone not a member of the auditing firm or in its employ. If the client cannot arrange to have any of the work that it may properly do carried out by its staff there is no objection, except expense, to having it done by the independent auditor. Indeed, until a comparatively short time ago much of this work was customarily done as part of an independent audit.

In a large and highly organized corporation it is quite possible that some of the functions in the representative program considered necessarily to be performed by the independent auditor might be taken over by the staff of the client if the system of internal control or the organization and the position of the internal audit staff would permit. That, however, would not relieve the independent auditor of his basic responsibility for supervision and review of all audit work, no matter by whom performed.

ELECTRONIC DATA PROCESSING AND THE AUDITOR

While the purposes and the results of an audit are the same whether a manually operated system or an EDP system or a combination of both is in effect, the methods of audit are necessarily quite different. The purpose of the audit is primarily to satisfy the auditor that the management's representations of the financial position and past operations "fairly present" them, and the result is a professional opinion that this is the case, or a statement of significant particulars insofar as this is not so.

The procedural details of this are the concern of the client's EDP staff, particularly the members responsible for programming, and the independent auditor. The financial executive's main interest lies in the assurance that EDP installations can be, and are being, satisfactorily audited.

Audit programs and methods are continuing to develop along with systems and equipment. Manufacturers of equipment and corporation programmers are conscious of their obligation to leave "audit trails." The independent auditor has a duty to keep himself fully informed of what is being done and to cooperate in every way with the client's EDP staff. This means not only study of basic EDP developments and principles but also a willingness to change deep-seated methods and ideas about the nature, timing, and direction of audit procedures.

There would be little value in trying, at this stage in the development of EDP, to formulate an audit program for an EDP system as comprehensive and definite as that possible for a manually operated system. Certain principles and requirements seem to be emerging, however.

The temptation to try to fit what we might call classic audit and recording procedures into the EDP frame must be strongly resisted. The results of the EDP system must be audited as such. This will generally mean that the timing of audit work will need to be changed. What could have been done at the end of the year under a manually operated system will need to be done much closer to the time of the transaction.

The auditor will need, first, to be fully familiar with the operation of the EDP system, and second, to follow its opera-

tions rather than to attempt to superimpose on them an audit technique inherited from a manually operated system. He will need to recognize that mechanical and arithmetic checks of the accuracy of EDP results are not of the same significance as similar checks and tests of a manual system and to judge the operation more by the nature and content of the programming than by any other factor. He should learn to recognize the difference between auditing "through" a computer and auditing "around" it.[3]

All this requires the fullest cooperation between the independent auditor and the EDP staff of the client. It may fairly be said that satisfactory results are otherwise impossible.

IMPORTANCE OF CLIENT-AUDITOR COOPERATION

In reply to the question, "Do you generally get adequate cooperation from your clients?" all international and national firms answering the questionnaire (Appendix A, p. 182) replied in the affirmative, and with few exceptions this was the answer of regional firms as well. While this indicates a generally satisfactory state of affairs, it does not necessarily mean that as much as possible is being done in the way of cooperation with the auditors. Management would do well to examine the situation to determine whether the utmost, instead of merely adequate, cooperation is being extended.

The next question, "If not, what in your opinion is generally lacking?" was answered by referring to cases where the client's staff was inadequate or where the management was in difficulties and was pursuing an evasive or ill-considered course of action. Other answers indicated that the auditor was at fault because of his failure to communicate satisfactorily with his clients.

Client-auditor cooperation is a continuing problem, and it is to the interest of both client and auditor to study the situation, not to arrive at a single permanent settlement, but to adjust from day to day as conditions change. As in so many other organizational situations, what we might call the natural tendency is the opposite of what is needed. In the operation of a

[3] Arthur B. Toan, Jr., "The Auditor and EDP," *Journal of Accountancy*, June, 1960.

system or method in several different plants the tendency is always against uniformity. Here the tendency is always away from the optimum of cooperation.

An unwarranted satisfaction with a method or procedure develops, a new condition is passed over unrecognized, or the need for certain work diminishes or disappears. It is greatly to the direct monetary advantage of the client not to let these things happen and to see to it that management and the auditor cooperate as fully as possible in all reasonable ways.

WHAT THE INDEPENDENT AUDITOR EXPECTS FROM THE CLIENT

Complete Access to Information

The auditor is entitled to expect from his client frankness, candor, and unrestricted access to all books, tax returns, cost accounts, correspondence, minutes, and other corporate records. Where government work of a secret or confidential nature is being done, arrangements should be made for at least one representative of the accounting firm to be cleared to inspect the secret or confidential records and data.

The client's protection in this context is the ethical requirement that the auditor shall not divulge information gained in the course of his work to any third party except with the client's permission or under subpoena. As client's records are all subject to subpoena under some circumstances, any disclosure under subpoena by an accountant could have been required of a company official or employee. There is a reasonably close analogy between the relationship of doctor and patient and that of auditor and client—a far closer analogy than between that of either pair to that of lawyer and client. The accountant is aiming at a fair description of his client's financial health. He is not defending a person or position, and he has a duty to be impartial and objective rather than protect or absolve.

Whereas full and free access to all corporate information is necessary if a satisfactory audit is to be made, this does not mean that all information must be available to every member of the auditor's staff who is working on the audit. It often happens that information of a confidential nature will be given

by the client to the partner in charge of an audit but not his staff. The amounts of some salaries or professional fees, not required to be specifically disclosed; the provisions of royalty or licensing agreements; special compensation agreements; conditions that might give rise to contingent liabilities; and uncompleted purchase or sale commitments covering investments or capital assets are examples of this type of information.

The financial executive has the duty to give this information to the independent auditor or to see to it that it is given to him. The auditor must then decide, first, whether the item or transaction has been correctly treated in the accounts and then whether there is any reason or requirement for specific disclosure.

Where access to corporate information is restricted, if it is not the result of ignorance or misapprehension of the auditor's duties and function, it is almost prima facie evidence of irregularity. The auditor should be very much on his guard and would have to consider whether he should specifically comment on any restriction in scope or whether, in extreme cases, he should withdraw from the engagement. Cases of restricted access to information because of an erroneous idea of an auditor's duties and the extent of his investigations can usually be dealt with by the exercise of a little tact and patience on the part of the auditor.

The foregoing is all predicated on the assumption that the client is the company under audit and that the auditor is acting under the authorization of the directors or stockholders of the company. This is not always so. The auditor's instructions may come from a creditor or committee of creditors of the company, a group of dissatisfied minority stockholders, or an intending purchaser of the company.

In such instances, although full and free access to all corporate information is just as desirable as in any other situation, its denial does not carry the same implications as it does when the client is the company under audit. The auditor, realizing the necessity for objectivity, also realizes that there is a certain adversary element in the company under investigation. His very presence is an indication of suspicion or doubt, and he must expect something less than full cooperation. There will seldom be outright refusal to give information, but little

or nothing will be volunteered. The auditor's requests for information will be followed literally, and if he does not ask for books or records by their correct names he may not get what he wants.

An investigation of this sort is a severe test not only of the auditor's technical qualifications but of his ability to handle men and situations with a combination of firmness, tact, and diplomacy.

Prompt Notification of Changes or Developments

There are several reasons why current information on the position, plans, and prospective actions of a client company should be given to the auditor as soon as possible.

One of the characteristics of modern auditing, including audits of systems using computers, is that the work is spread as evenly as possible over the year (see p. 89). This allows thorough and unhurried consideration of problems as they arise instead of in the rush of closing the accounts for the year; the audit work involved can be done when the problem first comes up, and valuable time saved.

Further, it is damaging to the client and frustrating to the auditor to find, in the audit of a transaction after the year end, that prompt action taken at or near the time of the transaction might have gained a tax advantage or avoided a danger, or prevented an embarrassing dispute with the Securities and Exchange Commission, or clarified a contract so vague or ambiguous in its accounting provisions as to make litigation inevitable.

Changes in operations or product lines without the auditor's knowledge might be unsupported by necessary changes in cost systems or estimating methods, or made without proper advice; such changes might involve unnecessary complications or losses. The following are examples of the kind of events and developments of which the auditors should be notified promptly:

Acquisition or sale of subsidiary companies.
New financial arrangements; loans, leases, or transactions in treasury stock.
Introduction of new product lines or dropping of old ones.

New equipment programs or changes in programs currently in effect.
Any unusual Federal tax developments.
Any unusual litigation or threats of legal action.
Results of storms, earthquakes, volcanic eruptions, and other "acts of God."
Effect of political changes on foreign operations, including currency restrictions and devaluations.
Fire losses and insurance recoveries.

Nothing can be lost by giving the auditor current information currently. A transaction will have to be examined and the audit work performed whether at the year end or at the time of the transaction. The only difference is the advantage to be gained by examining the transaction in time for this to be useful.

Assurance of Lack of Conflict of Interest

Although the management of a corporation should not have interests adverse to those of owners or creditors, if such a condition does exist the auditor should be free from pressure to conceal or minimize it. Apparent conflict of this sort is frequent, but on examination it generally develops that the interests in question are not in fact conflicting. Some examples:

Officers of a company operating under a bonus or profit-sharing plan might wish to inflate profits.

Officers of a company might wish to inflate profits to justify salaries or to facilitate an issue of securities.

Officers or stockholders might wish to inflate or minimize earnings to affect the market price of the company's stock.

Here the true interests may not really conflict. The auditor is entitled to the facts in the controversy, and armed with these he can generally show that in the long run everyone's interests are better served by a fair presentation of the financial statements.

The auditor is entitled to satisfy himself that no genuine and irreconcilable conflict exists, such as in the purchase of materials and supplies from companies controlled by officers, trading in the company's securities through concealed third

parties, or otherwise using a company position or company information against the company. While he can hardly expect the management to make a representation in writing that no conflict of interest exists in the company, no more than he could expect a representation that none of the officers are defrauding the company in any other way, he can and should be aware of the possibility of such conflict and take every reasonable means to satisfy himself that there is none. The auditor should inquire, discreetly of course, into any large outside business interests of officers, particularly if these have to do with providing services or supplies to the company.

As a part of the audit some work will be done on the purchasing department. It is here that there is, perhaps, the greatest opportunity for an officer or executive in effect to "trade against the company," and notorious cases have come to light in recent years wherein company officers have concealed financial interests in suppliers of materials or services.

Any dealings between the company and its officers or directors should come under sufficient scrutiny for the auditor to understand the nature of the transactions and to form an opinion of their legitimacy. Generally, such transactions are proper and in the company's interest. If, for example, the board of directors decided against developing a certain process or the purchase of certain real estate and some of the officers and directors thought well enough of the project to invest their personal funds in it, they should, if the project is successfully carried out, be entitled to a proper compensation for their expenditures and risks in the event that the company decides to go on with the development of the process or the acquisition of the real estate.

Great care and judgment should be exercised in dealing with situations of this sort. Personalities are involved, and even the appearance of questioning the integrity of directors and officers should be avoided. The auditor's position should be that of seeking information necessary to determine the fairness of presentation of the financial statements, and not of passing on the propriety of the transactions unless clear evidence of irregularity should come to light. Obviously these are matters for the attention of the partners of the firm of auditors rather than staff members.

Where it is the custom for the accounting firm to prepare the personal income tax returns of the company officers this usually provides enough information about their outside interests and investments to make further investigation unnecessary.

All executives, including those dealing with financial matters, are protected by any assurance the independent auditor can give that no conflict of interest exists between directors and officers and the company.

Cooperation in Spreading Audit Work Through the Year

The spreading of audit work through the year has been developing over a long time and has been accelerated by the advent of the computer. In the first two decades of this century the greater part of the work of an audit was done at or near the close of the year or in the months immediately following. This concentration of work was undesirable in many ways. It made it almost impossible for the accounting firm to maintain a permanent staff on a year-round basis large enough to handle the work in the so-called "busy season," say from December to April. Almost every accounting firm was forced to employ numbers of "temporary men." The supply of adequately trained accountants was not large enough to fill the permanent staff positions, let alone supply a large number of trained and competent temporary men. The quality of the temporary men was not high, and they filled out the year as summer hotel clerks, at race tracks, as salesmen of various sorts, and in similar jobs.

Two steps were taken to meet this condition: wherever possible, corporations were urged to adopt some fiscal year other than the calendar year, and methods were devised to make it possible to do as much audit work as possible before the end of the year. The advantages to both corporation and accounting firm are obvious. A great deal of audit work can be done during the year. Sometimes minor modifications of the client's records and methods were necessary to make this possible; in almost every such case, the company benefited from the change.

Inventories tested in September can be brought up to date merely through an inspection of perpetual inventory records through December 31. The adequacy of bad debt reserves

tested, say, in August, can be determined at the end of December by a survey to make sure that no changes in method have been made. Detail testing, where this is done to test the operation of the system rather than the specific items, and statistical sampling can be done as well at periods other than the close of the year.

A large corporation with domestic and foreign subsidiaries ordinarily prepares for internal purposes a monthly or quarterly set of consolidated financial statements. The examination and survey of principles of consolidation, particularly their application to new developments or conditions, can be made just as well a few months before the close of the year and brought up to date by a survey of subsequent significant changes as by making the same examination at the close of the year.

Any examination of a company's cost system for the purpose of establishing the fairness of the statement of work in progress can be made at almost any time provided the continuance of the system and methods to the end of the year is established. Spreading the audit work throughout the year can be successfully accomplished only by the continuing cooperation of the client company.

Supporting Schedules and Lists in Proper Form

Among the working papers that can be prepared by the staff of the client in preparation for the audit are trial balances, classified and analyzed; lists of accounts receivable, classified by age, location, or in any other necessary way, with notations of disputed items; lists of accounts payable; lists of securities owned, with changes since the last audit noted; schedules of significant purchases or sales of plant and equipment; inventory summaries covering materials, work in progress, and supplies, in as much detail as required; and schedules of capital stock issued and in treasury and of fixed obligations.

These papers should, of course, be prepared in consultation with the auditor to ensure that the essentials are covered, that nothing unnecessary is done, and that the information is presented in the form most useful to the auditor.

There is no objection other than that of poor economy to preparation by the staff of the independent auditor of any of

these papers if the office staff of the client lacks time or ability to do so (pp. 93–98). Working papers having to do with testing and verification should be prepared only by the staff of the auditor. The client's staff should not have access to them at any time, as this would reduce the moral effect of the audit and might suggest opportunities to the unscrupulous for covering up irregularities.

Working papers prepared in whole or in part by the staff of the independent accountant are, under the case of Ipswich Mills vs. Dillon,[4] clearly the property of the independent accountant. The question whether papers prepared by the staff of the client under the direction of the independent accountant are his property was not raised in this case and has not been adjudicated. However, the statement of the court that the accountants had the right to the ownership of the working papers for their protection "if the accuracy of their work was questioned" would indicate that all papers prepared under the independent accountant's supervision to support the financial statements would have been deemed to be the property of the independent accountant.

Coordination of Internal Audit Work with That of Independent Auditor

Internal auditing, particularly in the larger corporations, has not only developed greatly in recent years but, more important, has, to a great extent, changed its direction and its objectives (pp. 74 and 75). The functions of the internal auditor now include, in the well-organized corporation where the internal audit staff has the full support of management, review of organizational functioning generally as well as actual audit work and supervision of internal controls. In many corporations the internal auditor is used as a "trouble-shooter," often in fields a little remote from conventional accounting. One reason he can be used for this purpose is the preservation of his objectivity, which makes possible an independent and unrestricted investigation of a given situation.

Certified public accountants took an important and continu-

[4] Ipswich Mills vs. Dillon (200 Mass. 453); see *Journal of Accountancy*, April, 1936.

ing part in the development of internal auditing. Many internal auditors are certified public accountants and consider themselves as much professional men as when they were in public practice.

The public accountant and the internal auditor have, from the beginning, worked together harmoniously and effectively. They confer together on programs and audit manuals and on the division of work between the external and the internal auditor.

Adequate Space and Facilities

Under modern conditions in an enterprise of substantial size there will in all probability be partners, supervisors, or staff members of the accounting firm in the client's office at various times throughout the year. From December to the end of April they will be working on the audit of published financial statements, reports to the Securities and Exchange Commission and other governmental bodies, and the preparation or examination of various tax returns.

Finishing up the working papers and preparing some of next year's papers may be the next order of business. Internal audit reports may be examined, and if any special work beyond the audit is required, this would be a good time to take it up. In June or July, interim audit work on the current year can be started, and if properly arranged it can go on for the rest of the year.

All this does not involve any more hours of work than the old year-end rush. Instead of a much larger staff at the end of the year a smaller staff is employed more steadily, work is done under less stress, and disruption of the client's staff and excessive overtime in the accounting firm are avoided.

In order to audit in this way the staff of the independent auditor should be provided with a separate working room or rooms, equipped with telephones, filing cabinets, calculating machines, and whatever else of equipment and facilities is reasonably required. When audit work is going on access to the files and to the rooms should be limited to the staff of the auditor and those who have definite business with them.

The realization that the provision of these facilities is essen-

tial to a proper audit is a recent development in many companies. The old practice of letting the auditors have the directors' room or the office of a vice-president who is out of town to work in is fortunately a thing of the past in most corporations. The provision of proper facilities is a real help in making an effective and economical audit.

REPRESENTATIVE AUDIT PROGRAM FOR A MEDIUM-SIZED MANUFACTURING ENTERPRISE SHOWING DISTRIBUTION OF RESPONSIBILITY FOR AUDIT WORK

The independent auditor would in every instance make sufficient tests to satisfy himself that the work allocated to the client's employees was actually performed.

	To be done by the independent auditor	May be done by client employees
General ledger trial balance:		
Checked with general ledger	X	
Entered on working papers		X
Minutes of directors' and stockholders' meetings:		
Read; notes and extracts made	X	
Cash:		
Cash on hand counted:		
Audit date	X	
Interim internal audits		X
Certificates from depositaries received and checked	X	
Balances reconciled:		
Audit date	X	
Interim internal audits		X
Checks outstanding at end of period verified	X	
Deposits per bank proved in total with company records		X
Cashbook footings tested		X
Lists of checks received prepared by treasurer's office compared with deposits		X
General ledger postings tested		X
Accounts receivable postings tested		X

	To be done by the independent auditor	May be done by client employees
Notes receivable:		
Postings of notes receivable book to general ledger checked		X
Postings of notes receivable book to accounts receivable tested		X
Notes on hand at end of period checked with notes receivable book	X	
Notes out for collection confirmed:		
Confirmations prepared		X
Confirmations checked and mailed	X	
Notes under discount confirmed:		
Confirmations prepared		X
Confirmations checked and mailed	X	
Adequacy of reserve tested	X	
Accounts receivable:		
Customers' statements checked to trial balance	X	
Selected statements mailed direct to customers	X	
Differences in statements pointed out by customers reconciled	X	
Postings from sales books tested		X
Postings from credits and returns book checked		X
Postings from journal checked		X
List of accounts receivable at end of period classified by age and checked with accounts receivable ledger		X
Total of accounts receivable trial balance agreed with control account		X
Composition of outstanding balances examined for disputed items	X	
Authorization for bad debts written off verified	X	
Authority for credits and discounts checked	X	
Accounts receivable from officers and employees listed		X
Adequacy of reserve tested	X	
Marketable securities and investments:		
Complete list prepared		X
Securities on hand counted	X	

	To be done by the independent auditor	May be done by client employees
Securities held for safekeeping verified by certificate from depositaries	X	
Purchases and sales and profits and losses on sales of securities checked	X	
Income from securities checked	X	
Inventories:		
Physical inventory observed	X	
Items observed checked with records	X	
Differences reconciled	X	
Certificates as to quantity, quality and condition received from responsible officials	X	
Prices checked with market quotations	X	
Prices checked with latest cost	X	
Extensions tested		X
Footings tested		X
Summaries checked		X
Inventory tags checked to original inventory sheets		X
Percentages on process losses examined into and tested with similar percentages for previous years	X	
Interim tests of quantities		X
Purchase records immediately subsequent to period of audit tested to determine that liability has been taken up for all goods included in inventory	X	
Supplies:		
Certificates obtained from responsible officials as to quantities, quality and condition, with particular reference to any items which are obsolete or of which an excessive quantity was on hand	X	
Totals of supplies ledger proved with control accounts		X
Interim tests of quantities made		X
Prices tested with invoices	X	
Property, plant and equipment:		
Additions for year summarized		X
Appropriations authorizing additions for year examined	X	

	To be done by the independent auditor	May be done by client employees
Authorizations for sale or dismantlement of plant and equipment examined and compared with credits to property, plant and equipment account	X	
Plant ledger brought into agreement with control account		X
General examination made into the propriety of:		
Capital charges	X	
Allocation of payroll to company construction	X	
Allocation of material to company construction	X	
Allocation of overhead to company construction	X	
Reserve for depreciation:		
Calculations tested	X	
Rates compared with preceding years	X	
Authorization for change in rates seen	X	
Charges to reserve for property sold or dismantled and entries for salvage tested	X	
Depreciation used on income tax return checked	X	
Notes payable:		
Notes payable at close of period listed		X
Total of notes payable book and general ledger control account brought into agreement		X
Collateral deposited confirmed	X	
Schedule of receipts and disbursements on account of notes payable prepared		X
Interest accrued tested	X	
Interest paid tested	X	
Accounts payable trade:		
Large items listed		X
Total compared with open items in voucher register		X
Total brought into agreement with control account		X

	To be done by the independent auditor	May be done by client employees
Vouchers tested for:		
Authorization	X	
Distribution to proper account	X	
Clerical accuracy	X	
Receiving records where applicable	X	
Vouchers entered in the voucher register and/or payments shown by the cash-book subsequent to the date of the balance sheet reviewed to ascertain whether any of them are applicable to the period under review	X	
Bills on file, not vouchered or entered, examined to ascertain if any of them belong to the period under review	X	
Voucher record footings tested		X
Test examination made of monthly statements received from creditors having large balances	X	
Receiving records examined for the last day of the period for the purpose of ascertaining that the corresponding liabilities are included	X	
Wages and salaries payable:		
Total of payroll accrued brought into agreement with ledger accounts		X
Total of payrolls checked to ledger account for period		X
Footings and extensions tested		X
Time cards tested for authorization	X	
Changes of rates tested for authorization	X	
Distribution to operating and asset accounts tested	X	
Other accrued liabilities:		
Schedule prepared		X
Contracts, agreements or similar data examined where amount is material	X	
Capital stock:		
Amount outstanding verified by certificate from registrar and transfer agent	X	

	To be done by the independent auditor	May be done by client employees
General journal:		
Postings and footings checked		X
Entries scrutinized, particularly closing entries affecting fixed assets, investments, deferred charges or reserves	X	
Surplus or retained earnings:		
Schedule prepared showing changes during the year		X
Schedules prepared showing details of adjustments and extraordinary items		X

5

Forensic Accounting

SELECTING AND USING AN ACCOUNTING WITNESS

One function of the C.P.A. evolving steadily over the years is that of representing his client or his client's point of view or position before various courts and regulatory bodies or in other public forums.

The importance of this type of representation can hardly be overestimated. The financial executive is generally the company officer most concerned with litigation, representation, or negotiation where the issues are accounting or financial. It is usually his responsibility, working with the company's legal counsel, to decide, first, whether accounting testimony or representation is necessary, and second, who the witness should be.

In most situations the client should be represented by a partner of the firm that is the company's regular auditor or accounting advisor. In appearances before the Internal Revenue Service, the Securities and Exchange Commission, agencies having to do with government contracts, and similar agencies, this is the usual procedure.

Sometimes it may be desirable to support the company's own accounting advisors by a representative of another firm. This is more often true in formal litigation before a state or Federal court, where it is customary for the accounting and financial facts to be presented by the accountants for the company. Testimony on the applicability and the propriety of accounting methods or principles would then be presented by members of another accounting firm.

Qualifications

The representation of a client by an accountant is not an everyday occurrence, and usually expert testimony or appearances on behalf of a client before governmental bodies are so far as time is concerned a small part of an accountant's work. When the necessity arises, however, the choice of a representative should be made with the greatest care. Technical accounting qualifications and, generally but not invariably, familiarity with the industry are necessary, but the accountant's appearance, manner, articulateness, and particularly his ability to hold his own under cross-examination are just as essential as his professional qualifications.

Obviously only a man of experience and standing in the profession should be chosen as a witness in a case important enough to be litigated. The best way to choose a satisfactory witness is to consult his professional brethren, either his own partners or his friends in the profession.

The Accounting Witness and Legal Counsel

A common mistake is to defer the choice of an accounting advisor too long. An accountant experienced in litigation can often be of great assistance to the attorney in planning strategy from the beginning of the litigation, and it is difficult for the accountant and attorney, and may be expensive and damaging to the client, for the accountant to be brought in just before the trial is to begin. He may find that the attorney has misunderstood some vital accounting point which would necessitate a complete revision of the attorney's strategy. It is even worse if the accountant is instructed to cover some specific points and is left in the dark about the case as a whole.

Every accountant of any experience or standing knows enough about the law to understand what an attorney is trying to do, and he also knows enough not to interfere or volunteer advice on purely legal matters.

If the accountant is taken fully into the confidence of attorney and client he can be of the greatest help and will do nothing to hinder the working out of the attorney's basic strategy.

Instead he will generally be able to offer some really constructive suggestions.

WHAT FORENSIC ACCOUNTING IS

"Forensic accounting" seems to be the best term to describe these activities of the accountant. "Forensic" is already the adjective in common use to describe similar activities of physicians and psychiatrists when giving professional testimony before a court. The analogy with the accountant acting as an expert or as a witness to facts in the different forums where he is qualified to appear is close enough to warrant its use.

The accountant from the earliest days of the profession has performed some of these functions. He has acted as a witness in courts of law and, particularly in England, in arbitration matters. From the earliest days of the profession in England the auditor attended shareholders' meetings, prepared to answer questions on the financial statements.

In this country the growth of these functions follows mostly from the increasingly close relationship between government, state or Federal, and private business.

Development of Forensic Accounting

Perhaps the strongest influences in this direction have been the adoption in 1913 of the XVIth Amendment to the United States Constitution, providing for a tax on incomes; the passage, in 1933 and 1934, of the Securities and Exchange Acts; the growth of arbitration encouraged by the work of the American Arbitration Association and the passage of state laws recognizing the validity of arbitration awards; the organization of the various state public utility commissions; the expenditures during and after the Second World War for military and defense purposes and the negotiations and disputes arising from them which in turn caused the creation of the various boards concerned with the settlement of disputes and termination and renegotiation of the contracts; and the creation of such Federal commissions, as the Federal Trade Commission and the Federal Communications Commission.

All of these bodies require at one time or another the repre-

sentation before them of clients subject to their jurisdiction. While it is true that the accountant should always work in close cooperation with his client's legal counsel, it is also true that he is usually the best witness and advisor on financial or accounting questions.

Accountants are also appearing with increasing frequency as witnesses before Congressional Committees, usually as representatives of trade or professional associations. At times an individual accountant will appear before a committee at the request of the chairman or some individual member. In addition to his appearing before various governmental bodies as the representative of a client, the accountant also frequently appears as a witness in civil cases wherein the government is not involved and occasionally in criminal proceedings on fraud or embezzlement.

Accountants Are Not Advocates

Although the bodies before which he may appear are many and varied and the subjects on which he may testify cover a wide range, the accountant always appears in one of two capacities: an impartial expert in accounting or financial matters, or an objective and unbiased witness to facts.

When a doctor testifies to the nature and extent of the injuries received by the plaintiff in a damage suit he is practicing forensic medicine. He is not appearing as an advocate but as an impartial, expert witness anxious to establish facts in order that justice may be done. He is appearing before a legally constituted tribunal and is retained by one of the parties to the case. If he is a competent and honorable practitioner, as most doctors are and as all are presumed to be until proved otherwise, the source of his fee will not warp his judgment. Naturally, he would not wish to appear as a witness if he felt his testimony would be damaging to those who retained him. He would not appear in a case unless he felt his testimony would be helpful. But he would frequently suggest that those who retained him should moderate or change their claims.

The difference between acting as an impartial, expert witness, or as an interpreter of technical data and accounting prin-

ciples, and acting as an advocate is one that should be clearly stated and universally recognized. Advocacy implies two things: the existence of opposing parties and the right, if not the duty, of each advocate to present his side of the case as well and persuasively as possible. One looks to an advocate for a clear and honest presentation of his contentions but not for an impartial survey or estimate of the entire situation.

The preparation of data for regulatory or other governmental agencies and the appearance before such agencies as a witness to facts or to accounting principles or their application, is essentially forensic accounting practice rather than advocacy. Here we do not have two contending parties. We have a tribunal, the agency before which those subject to its regulation appear. There can be no question of adversaries here. The government agency would not take the position, indeed would not admit, that it was seeking a victory over those appearing before it. The only position the agency could possibly take would be such as that of an arbitrator anxious to establish facts or to do justice or an investigator trying to get a correct picture of a given situation.

This being so, the position of the public accountant is that of a witness to facts, an interpreter of principles, or an exponent of data too complex or difficult for the unaided comprehension of a layman. On some occasions the privately employed accountant may also take this position.

There is no place for advocacy here. If the accountant, public or private, distorts or suppresses facts or gives interpretations he knows to be wrong he does not thereby become an advocate. He merely becomes an unethical and perjured accountant. He must practice, in his forensic capacity, with a full appreciation of his peculiar responsibilities and qualifications. If he deviates from this standard he should be subject to the severest discipline.

Duties of the Expert Witness

The C.P.A. has no duty to act as a witness or in any other forensic capacity if he is requested or instructed to color his testimony or to suppress vital facts or information. The fact

that any testimony he may give would be damaging to the party seeking his services is sufficient reason for declining to act as an expert witness.

Everyone, no matter how apparent his guilt may be, is entitled to the benefit of competent legal counsel. But there is no such right to be represented by an expert witness. A material witness to a crime may be subpoenaed and detained by the court. Under some circumstances witnesses in civil suits may be subpoenaed; here, however, the court is interested in facts only. No court, however, has the power to subpoena an expert witness, unconnected with the case on trial, merely to give his expert opinion on an assumed or actual set of facts.

The accountant as an expert witness has but one duty: to give and if necessary defend his professional opinion on a given or assumed set of facts, which opinion is based on experience and is arrived at after adequate research and study. As a witness to facts his duty is to satisfy himself of the facts to which he testifies by any proper means available to him and to make them clear to the court or any other body before whom he is testifying.

THE ACCOUNTANT AS A GOVERNMENT WITNESS

Both the government and the accountant are put in a difficult position when expert testimony is required in a proceeding by the government against a corporation or individual. It is, in an intensified form, the dilemma of the accountant asked to act as an expert witness in a proceeding against another accountant or in a case where each side brings accounting testimony in support of its position.

This situation can hardly arise where the testimony concerns facts only. The duty of an accounting witness asked to conceal or distort facts is clear: he withdraws. But where one witness has access to more and different facts than another, the apparently conflicting testimony may be useful in clearing up the situation.

The real problem arises when there is a conflict of opinion. If the accountant who is requested to testify agrees with the opinion or position of the Justice Department, the Internal Revenue Service, or the SEC, for example, he has the same

responsibility toward the government agency that he would have to any party in any litigation who requested him to testify.

There is, however, a natural reluctance to appear to be against business or to be unduly favorable to government, as the accountant's customary attitude would more likely be to support his client's position against government allegations of error or misinterpretation. The accountant could hardly be expected to testify against his own client in any circumstances.

If the adversary of the government is not a client of the accountant and he is convinced of the soundness of the government's position, he should have no more hesitancy in testifying for the government than he would have in testifying to the same accounting principles and practices or to the same business customs or trade practices for a private individual or corporation.

The same limitations hold with government agencies as with individuals and corporations: it is the accountant's decision whether he should testify; he must be sure that his testimony, as a whole, will be helpful; and he must be in general agreement with the policy and views of the party for whom he is testifying. Although the accountant has no legal duty to testify for the government, if these conditions are met he should consider very carefully whether he may not have a moral duty to do so. If qualified professional accountants consistently refuse to testify under such circumstances, the place they should occupy may be taken by others less qualified, and injustice and confusion may well result.

ACCOUNTING TESTIMONY IN ACTUAL CASES

A few instances of the effect of accounting testimony in actual cases should give the financial executive a better idea of the practical importance and value of adequate accounting testimony and representation. Whenever an accounting witness testifies or an accountant represents a client before a governmental body or agency his testimony has either an actual monetary effect and value or is directly concerned with the operation and continuity of the enterprise. One of the most obvious examples is in tax practice. Accounting testimony before the Tax Court, the Court of Claims, or other Federal court

is frequently the determining factor in the decision. Occasionally, as in cases of alleged fraud, the accounting testimony may serve to clear the client, as happened in one case where the method of determining income was clearly not that required by the statute and fraud was alleged. The accounting testimony established that the method employed, though not that required by statute, was one that could have been employed as the taxpayer contended as the result of an honest mistake. Additional tax and interest were assessed, but no fraud penalties imposed.

Practically all personal contact of the accountant with the Internal Revenue Service is a type of forensic representation, and one of the most important. The financial executive and his assistant in charge of tax matters should be in close touch with this work from the beginning.

In the litigation of cases where the government is not a party, accounting testimony may be decisive in determining such factors as the amount of damages suffered by a breach of contract, a loss by fire or otherwise covered by insurance, or a claim under a surety bond.

Interpretation of a Mineral Lease

In the interpretation of a mineral lease, where the rent was a proportion of the profits earned by the lessee from the operation of the property, the lessee contended that, although it fully intended to pay rent as stipulated in the lease, no profit had, in fact, been earned from the operation of the property. The matter was the subject of arbitration, before a single arbitrator.

The accountants for the lessor examined the methods of cost allocation and accounting of the lessee and were able to show that profits, properly attributable to mining operations, were diverted to operations of the lessee alleged to be services rendered to the mining operations as independent enterprises. These so-called service enterprises consisted of an electric power plant, a railroad on company property not serving the public, docks and wharves, and other facilities used exclusively for the mining operations.

Charges for these service facilities at so-called going or

market rates, greatly in excess of cost, were made to the mining operations, thus diverting mining profits to these operations and reducing or eliminating the mining profits on which the rent of the property was calculated.

The accounting testimony showed that it was the invariable practice in the mining industry to charge service facilities against mining operations at cost rather than some assumed market rate, thereby showing a substantial profit on mining operations under the lease.

The lessee presented no accounting testimony in contradiction to that of the lessor, and the matter was settled out of court to the satisfaction of the lessor.

Diversion of Corporate Assets

An example illustrating the importance of testimony in a litigated matter is a case in which the court ordered an examination where two brothers-in-law had organized a business ten years prior to litigation, each investing $1,000. A brother of one of these two was employed as a bookkeeper and clerk and was promised he would receive the same compensation as the other two but no stock interest. The company prospered and in ten years was earning approximately $750,000 per year in addition to the salaries of $70,000 for each of the three individuals.

The brother not a stockholder claimed that he was entitled to a one-third stock interest. He was supported in his contention by his brother and opposed by the brother-in-law. The court appointed auditors to determine the status of the company.

It was found that a number of affiliated companies, primarily sales companies, had been formed in which the three individuals owned equal shares. After the dispute as to the ownership of the parent company had begun, a new sales company was formed in which the three individuals shared the stock ownership. It was further found that the parent company owned by the original two investors owned all of the patents and formulas that were the basis of this new company's success. Without the knowledge of the dissident brother-in-law, all of the business of the parent company was transferred to the new

company which used all the patents, formulas, etc., without compensating the original company therefor. As a result, the original non-investor of the three was now benefiting by owning one third of the company that had, in effect, been substituted for the parent. Testimony by the accountants in court brought forth all of these facts.

Company vs. Foundation—Administration of an Estate

Important testimony of the accountant in a litigated matter between members of a family resulted in a recovery in excess of $4 million.

The founder and 60 per cent owner of a very prosperous business died and left his shares of stock in trust, the income on the shares to be paid to his widow during her lifetime, then to his three sons and three daughters. Upon her death and upon the death of his last surviving child, the corpus was to be distributed to the grandchildren or their issue. The widow and six children formed the Board of Directors of the company. During the widow's lifetime a charitable foundation was organized to which she donated a few shares of stock of the company. Subsequent to her death, one of the sons fell into disfavor with the other members of the family and was ousted as a director and employee of the company.

Subsequently, when some of the grandchildren had reached maturity, they started a suit to determine whether their uncles had properly administered the estate to which they were the beneficial legatees.

The accountant's examination disclosed that the remaining 40 per cent of the shares of the stock of the company, which had been in the hands of employees, had been purchased by the charitable foundation. The money for the acquisition was supplied by the operating company either through direct loans or through the use of their bank credit. As a result, the foundation owned 45 per cent of the company. Inasmuch as the company had a worth of approximately $10 million, the diversion of these assets to the foundation deprived the ultimate beneficiaries of this sum.

Based upon the disclosure of the accountant, the holding of the court was that inasmuch as the funds of the company had

been used to acquire these outstanding shares, the acquired shares rightfully belonged in the treasury of the company and not to the foundation.

Fraud in Public Construction Work

A group of contractors had been indicted for conspiracy in rigging a bid for public construction work. The contention of the defendants was that the profits earned were nominal. The accountants took serious exception to the profit computation.

The examination by the accountants disclosed that each of the contractors had submitted sizable invoices every month for equipment that was never used on the project but was supposedly being held available on standby. By diligent analysis the accountants determined that this equipment was most frequently being used on other construction jobs. The defendants had also claimed an allowance for the cost of their overhead.

The accountants in their testimony disclosed to the court that the defendants had formed a separate syndicate which was completely self-contained, and at no time were there any overhead costs of the defendants applicable under the circumstances.

Damages Determined in Patent Litigation

After some years of litigation, the heirs of an inventor were declared to be the owners of a patent. The inventor was an employee of the company but was not employed in a technical capacity; he perfected the invention on his own time and in his own premises, thereby defeating any claim of the company for shop right. The inventor died while the suit was in progress.

At this time accountants were called in to determine the damages suffered by the heirs of the inventor. The agreement between the company and the inventor provided that the company was to manufacture under the patent for an indefinite but presumably short period, at which time the inventor should be compensated for the patent on the basis of its established value.

The period during which the company manufactured under

the patent was extended to many years by the company's refusal to admit the validity of the patent and the ensuing litigation. The compensation to the heirs of the inventor was, therefore, established on the basis of many years of profitable operation.

The accountants investigated the sales and cost records of the company as well as the allocation of various expenses to product lines and were able to establish an amount of damages, with interest, of approximately $2,500,000. The case was appealed to the United States Supreme Court and a decision was given for the heirs of the inventor.

ATTITUDE OF THE ACCOUNTING PROFESSION TOWARD GIVING EXPERT TESTIMONY

While there are few, if any, accountants who would care to be known as "professional witnesses," it is nevertheless true that some accountants are more experienced and better qualified for this work than others.

In answer to the question, "What are your views on the place of the C.P.A. as an expert witness?" the international and national firms all replied that they thought the accountant had an important place as an expert witness. The smaller firms agreed, but some had difficulties with clients and lawyers, and some said, with commendable candor, that they did not care for "the publicity and brow-beating associated with trials of any kind."

These answers (see Appendix A, pp. 191–194) give a good cross-section and summary of the views of the accounting profession.

6

A Look at Professional Accounting

CHANGES IN THE PROFESSION

Why should the financial executive, or any other businessman for that matter, need or want to study the development of a profession that serves him? He is primarily interested in results, not history. But because the needs and pressures of business have been a predominant factor in the development of the accounting profession, an understanding of the nature and results of those changes may well be one of the most powerful weapons the executive has at his command to attack the ever-increasing complexity of the problems with which he must deal.

It is a well-recognized fact of business life that the success of many executive heads of important corporations is primarily based on their ability to use and interpret financial and statistical statements, and the number of such men who have risen via the accounting route, either as C.P.A.'s or as company accountants, is growing rapidly. Among many examples are presidents of automobile, earthmoving, steel, electrical manufacturing, and copper mining corporations of national and international scope, as well as many in smaller enterprises.

Resources and Objectivity

It is a practical impossibility for any corporation, no matter how well-organized and efficient, to have at its command in

one specialty the equivalent of the resources of a well-organized accounting firm. It would be most difficult to organize such a department in a corporation and, as the demands for such services are of a highly fluctuating nature, it would be prohibitively expensive.

Another reason why it would be undesirable even if possible for a corporation to perform these services for itself is that a public accounting firm brings a fresh and objective point of view to its work, uninfluenced by any commitments to previous methods and policies. This objectivity is just as important in such management services as system work, projections of results of new methods or policies, and the various phases of budgeting, as it is in the criticism and review of financial statements for third parties.

For all these reasons it is imperative particularly for a financial executive and to some degree for any other executive to understand what to expect and demand from their professional accounting advisors, especially in this time of rapid and revolutionary change.

Answers of representative firms to the query in the author's questionnaire, "Are your clients fully aware of the various types of service you are to render?" indicated that the larger firms were almost unanimous in the opinion that many, if not most, of their clients were not fully aware of all that the C.P.A. firm could do beyond the traditional services. Many tax and audit clients do not seem to know that their accounting advisors are the best people to go to for help in marketing, cost reduction programs, projection of results of new policies or products, or any other of the many services that a well-organized management advisory services department can provide.

The local and regional firms were almost equally divided on this question. The reason clients were more aware of what the smaller C.P.A. firm could offer seems to be that they are in closer and more constant touch with their clients. Representative answers are given on pages 167–169 in Appendix A.

In answer to the companion question, "If not, are you taking steps to remedy this condition?" all but one of the large firms answered in the affirmative (pages 169 and 170, Appendix A).

Among the local and regional firms there seemed to be more difficulty in getting clients to realize what could be done for

them, although 2 out of 3 were making some efforts in this direction. Some of the difficulties are brought out in the representative answers given on pages 169 and 170.

The Period of Evolution

As for all revolutions, it is difficult to say exactly when the accounting revolution began. There was a long preparatory stage in the French Revolution, perhaps fifty years. It did not begin on July 14, 1789, with the taking of the Bastille but actually many years before in the minds of Diderot, Voltaire, and Rousseau.

In the accounting profession in the United States evolution from 1900 on was rapid but still not revolutionary. Methods of financial accounting were devised for the control of the property and the presentation of the financial statements of large enterprises made up of many formerly independent units. The development of both the theory and practice of consolidated accounts was, perhaps, the greatest single contribution to accounting theory in the United States in this period. Although developed largely by accountants of British birth and training, the treatment of consolidated accounts was nevertheless far in advance of British and other European methods of the time.[1]

Inventory methods, principally the last-in, first-out (LIFO) method, an outgrowth of the British base stock method, were developed that permitted a more exact matching of current costs and current sales or income. Many improvements were made in the area of internal control. Statistical sampling methods were developed and introduced where they were appropriate, and analytical auditing, particularly in the processing industries, supplemented and to some extent replaced the older methods of detail voucher auditing. In cost accounting, standard costs were the logical development from the earlier job costs, carried out by accountants and industrial engineers. They became one of the most useful of management tools.

Other developments were closely associated with the growth

[1] A. Lowes Dickinson, *Accounting Practice and Procedure* (New York: The Ronald Press Company, 1913), Chap. 8. G. R. Webster, "Consolidated Accounts," *Journal of Accountancy*, October, 1919, pp. 258–272.

and improvement of mechanical accounting methods and devices. These perhaps did not develop as fast as the needs of business required, but great strides were made. The invention of a device for printing credit balances as such on adding machine statements made it possible to develop bookkeeping machines from what were formerly mere adding devices. The invention of a printing device for card-operated machines of the Hollerith type, later developed by International Business Machines, greatly increased their value. The general use of electric motors on adding and calculating machines was another step forward.

Revolution Overtakes Evolution

Important as these developments were they were still little more than extensions of the earliest type of double-entry bookkeeping and of Blaise Pascal's seventeenth century calculating machines. Accounting statements were limited to records, compilations, and analyses of actual transactions. Because of the limitations imposed by time, expense, and the number of people required to gather the information, they did not even give all the information that would have been useful about the actual transactions.

The functions of accounting were not different in principle from those of the record keeping of the bankers and merchants of the fourteenth and fifteenth centuries, which may be described by record and function as follows:

Daybook or memorial—Compilation
Journal—Coordination and Computation
Ledger—Classification
Trial balance or statement—Communication

These five functions are still the basis of accounting no matter what mechanical means may be employed, but the revolution in accounting came when it became possible to push classification and analysis to the desired limits quickly enough to be useful and significant and it became a practical possibility

to work out as though they were actual transactions as many hypothetical situations as might bear on a particular problem.

Administrators and accountants had dreamed for years of some method of getting information soon enough and cheaply enough to allow operators to make decisions based on all the facts rather than partly on only some of the facts and partly on hunch, and to enable control over operations, including purchases and inventories, on an even better basis than was obtainable with the best mechanical devices and under the best standard cost methods then in use.

How much further these functions may be extended in the future we do not know, but that they will be extended is hardly open to doubt.

The Electronic Breakthrough

The electronic computer, although originally developed for scientific and technical purposes, was ideally fitted to meet this need, and it can fairly be said that this was the great breakthrough that marked the beginning of the accounting revolution.

About all we can say for certain is that it is a revolution, not an evolution, that it is well under way, and that everyone concerned—administrator, accountant, teacher, and engineer or technician—must, while doing everything possible to use what now exists, welcome and help in further developments and improvements.

The Securities and Exchange Commission

In the dark days of the great depression there was a widespread feeling, somewhat exaggerated it is true but nevertheless founded on fact, that there were many things about the securities markets that should be corrected and that there were certain abuses that should be eliminated. This had a bearing on corporate financial statements although no serious abuses and few important deficiencies were alleged in corporate accounting as such. Published corporate accounts had already been the subject of correspondence between the listing committee of the New York Stock Exchange and the then Ameri-

can Institute of Accountants.[2] This correspondence formed, to a large extent, the basis for the accounting provisions of the Securities and Exchange Acts.

Although the changes in the accounting methods of corporations listed on registered stock exchanges were neither substantial nor sweeping, the changes in the responsibilities of the auditors and other experts resulted in the imposition of heavy liabilities on them if statements were not, in the language of the Act, so framed as to be "not misleading."[3] These liabilities to third parties were much more extensive than those indicated in the case of Ultramares vs. Touche, the leading case on third-party liability of accountants up to that time.

Although the requirements of the Securities and Exchange Commission demanded no more of the auditor, so far as actual independence and objectivity were concerned, than the best standards of the time, there was a considerable amount of soul-searching among accounting firms to make sure that they were actually conforming to those standards.

The Securities and Exchange Commission and the accounting profession, particularly as represented by the American Institute of Certified Public Accountants, have from the beginning cooperated fully. Because of this cooperation, the powers given to the SEC over accounting methods have seldom been exercised, and the influence of the SEC in the evolution of accounting has been helpful and strengthening to the accounting profession.

Taxation

The impact of taxation on accounting has been discussed earlier in Chapter 3. Here we need only reemphasize that the influence of the corporate income tax has been tremendous. Because of the complexities in determining taxable income and shaping corporate transactions most advantageously, the importance of the accountant and the services he can render to

[2] "Report of the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants to the Committee on Stock List of the New York Stock Exchange," dated September 22, 1932, quoted in full in George O. May, *Financial Accounting* (New York: The Macmillan Co., 1943), pp. 72 ff.

[3] See Section 11 of the Securities Act of 1933.

business management have been greatly increased. The effect of the corporate income tax on accounting theory and practice, however, has not necessarily been in the direction of advance or improvement.

The purposes of tax and corporate accounting are not the same. The collection of the full legal tax due, rather than fair presentation or the provision of information for the operation of an enterprise, is the object of tax accounting, and while tax and corporate accounting must be reconciled, tax methods have no necessary validity as accounting practices.

Education

The burden imposed on the teacher by the accounting revolution is particularly heavy. Until the advent of the computer the accountant had little need for higher mathematics. Many accountants were mathematicians, but it had not much more relation to their daily work than if they had been violinists or painters, as many of them were.

From now on higher mathematics, including calculus, the mathematics of probabilities, and the ability to construct and understand mathematical models, will be a necessary part of the preparation of the young man or woman expecting to enter professional accountancy.

Growth of Professional Accountancy

The revolution so far has been well ordered and comparatively bloodless. As in all revolutions some are leading, some are following, and some are holding back. Some perhaps may not even realize that a revolution is taking place.

The survey conducted by the author shows that most firms are prepared to render the services called for by the new conditions stemming primarily from the use of computers. Many of the regional and local firms as well as national and international firms are prepared to render these services, and others have made arrangements to provide them as the occasion demands through cooperating accounting firms. Very few regional and local firms are ignoring this development, although some seem a little apprehensive about it.

The revolution in the methods and machinery of accounting

has been accompanied by corresponding changes in the required qualifications of the personnel of the profession. Here again the process was until recently an evolution rather than a revolution.

A brief review of the history of the profession in this country will show why this is true. Before 1900, to use a convenient bench mark, professional accountancy in this country was largely in the hands of British firms whose principal duties were to look after the interests of British and other foreign investors in American railroads, breweries, meat-packing establishments, and other industries and to examine and report on the American operations of British insurance and shipping companies.

While this work remained important for many years, around 1900 the era of combinations of units of various industries into large consolidations began, and the work involved became more and more important. American accounting firms began to develop, although it was not until the time of the First World War that the supply of professionally educated American accountants began to increase substantially and the profession ceased to depend on Scotland and England for recruits.

It was also in this period that the foundations of the organized profession were laid. State and national societies were organized, C.P.A. laws were passed, and an International Accounting Congress was held in St. Louis in 1904.

The Pioneer Practitioners. To understand how the accounting profession has evolved and developed, a backward look to those formative years is necessary. It was a profession small in numbers, made up of men dedicated to making this new profession respected and useful who had a keen appreciation of the fact that they were taking the old routine, the ancient technique of the double-entry, and developing it into something that would protect the public, guide and stabilize business, and take a vital part in the expansion of enterprise that they saw was inevitable.

The founders of many present-day accounting firms were among these men. They were individualists and practical idealists, besides being forceful and colorful characters. Even in

the days before the Sixteenth Amendment and income tax work swelled the ranks of the profession, they were navigating the then uncharted seas of accounting theory, business management, and corporate finance. Their task was not to choose between accepted methods nor to determine whether a given practice was generally adopted. More often than not they had to create or devise their own methods.

What could be learned in a school or college was essential, but limited. In those days many leaders of the profession began their careers after graduating from high school by taking such positions as they could get, occasionally as junior accountants, and studying as much accountancy as was offered at one of the universities in evening classes. Up to the time of the First World War, it was quite possible to get all the theoretical and academic training available and to qualify for the certified public accountant examinations after three to five years of evening study. The examinations for the C.P.A. degree covered, at that time, what now seems to be the simple and rather limited essentials of the technical and theoretical requirements for the practice of the profession.

Emerging Requirements. It was not until January 1939 that New York required a college or university degree and certain minimum accounting and other courses as a prerequisite for taking the C.P.A. examination. Most states required evidence of graduation from a high school, and some, but far from all, required a certain number of years of employment with a C.P.A. or C.P.A. firm before a candidate could be certified. Before 1916 every state set its own examination, and these varied widely in scope, difficulty, and standards of marking between the different states.

In 1916 the American Institute of Accountants was organized and set its own examinations for admission to the Institute. These examinations could also be used by the states. The first states to do so were California, Colorado, Florida, Michigan, Missouri, Nebraska, New Hampshire, and New Jersey, but it was not until 1955 that the examinations of the American Institute of Certified Public Accountants were used by all states including the then territories of Alaska and Hawaii.

What is significant in this historical background is that it illustrates, first, the lag between ever-increasing business and professional requirements and education, and second, the lag between education and the professional examinations.

Any general professional examination is a test only of minimum requirements at an early stage of the candidate's professional career. The examination should be difficult enough to exclude the basically unfitted or incompetent, but not so demanding or particularized as to keep out candidates who may eventually become competent members of the profession. It should not, and probably cannot, test the candidate's ability in specialized fields but can only assure the public that the candidate has a certain basic education and ability that will probably allow him to develop into a valuable member of the profession at some later time.

The accounting revolution has made the gaps between practice and education and between education and the C.P.A. examination even wider. The financial executive or businessman seeking professional service or trying to evaluate its quality, particularly in specialized fields, has a most difficult problem. If he needs advice on a complex situation, he has very little to go on that is positive and definite, but must rely on the accountant's general reputation. Few types of work encountered in the accountant's experience can be discussed in detail with third parties. The accountant cannot tell one client the full, or even the significant, details of what he has done for another in giving advice on the full effect of a proposed combination or merger, the tax consequences of a many-sided and complex group of transactions or course of action, or the probable results of several different approaches to a cost, operating, or sales program (simulated problem solving in operations research). The prospective client has little more to rely on than general statements about the accountant's experience and ability.

If the businessman's accounting advisor is not a C.P.A. it is probable that he will not receive the services he needs. But that is only a negative precaution. He must, to a large extent, take the accountant's word for what he is qualified to do. Recommendations have some value, but one client will seldom tell another the details of the work that has been done. Recom-

mendations are usually confined to something like "Sharp and Keene are a very good firm." "They saved us a lot of money." "They got us out of a lot of trouble." or "They helped us get that stock issue through."

SPECIALIZATON. Whether the firm be large or small, the prospective client should know whether the services he needs are available. It may generally be assumed that, taking into consideration size and geographical distribution, any reputable firm or individual practitioner can perform an audit leading to a certified statement and can prepare a correct tax return.

Many small firms or individuals have special qualifications in particular fields or industries. Some have, for example, considerable experience in bankruptcy, others in government contracts or the purchase and sale of businesses. The small firm or individual frequently has an intimate knowledge of particular industries: the garment trade in New York City, ranching in Montana, real estate, or club and hotel operation.

In general the smaller client is well served by the small firm. He will be assured of the personal services of the partner he knows, and he will have some assurance that the men on the job will be familiar with his industry. The larger firm will have partners and staff familiar with the problems of the smaller enterprise, and the small client of the large firm should not fear that he will get "lost in the shuffle."

The large national or international corporation will, of course, require the services that only a national or international firm can provide. Work for foreign offices or subsidiaries, the application of the new techniques dependent on electronic data processing, special tax representation, and work on mergers—actual or prospective—are only a few of the things a prospective client might require. Without making full and careful inquiry he will still not know the answers to questions that may be vital to him.

It is hoped that in this book the financial executive or businessman, large or small, can find both the type of questions he should ask of an accounting firm to help him decide whether he can get the services he needs and the means to evaluate the answers after he gets them.

PUBLIC RELATIONS AND ETHICAL PUBLICITY

The Financial Executive and Accountants' Professional Ethics

At first sight it might appear that the professional ethics of the practice of accountancy is an internal matter for the profession and of little interest to the financial executive or management of a client company. In some respects this is quite obviously untrue. The client is clearly interested in the ethical rules requiring that information concerning the client should be given to third parties only with the client's permission or under subpoena. The observance of the rules regarding independence always affects the client directly.

There are other rules, however, where the interest of the client is not so clearly evident, principally those having to do with advertising and solicitation, competitive bidding, and the sharing of fees or paying of commissions to non-accountants for obtaining accounting engagements. The client does have a definite interest in the observance of these rules by the accountant. If accountants were permitted to advertise, if they submitted competitive bids for accounting engagements, if they paid commissions to those who brought them work, the standards of professional work and particularly of independence and objectivity would immediately suffer.

The accountant renders a service of an intangible nature. He must be the judge of the sufficiency and adequacy of his own work. If he were under constant pressure through competitive bids to reduce his fees, the tendency would be to reduce both the quantity and quality of work done. The usual safeguard for the maintenance of quality in commercial operations, that is, the possibility of an appraisal of the quality of the work by the purchaser, would be absent, and the resulting decline in professional standards would be damaging both to the business community and to the accounting profession.

This is demonstrated by the fact that, in the early part of this century, the accounting profession went through a period wherein some firms pursued highly unethical methods of obtaining business. The resulting conditions became so bad that

the accounting firms that were determined to maintain high standards, fortunately in the majority, were forced to take decisive steps to prevent such practices as advertising, competitive bidding, and the payment of commissions to non-accountants.

As a part of this development, provisions were inserted in the various state C.P.A. laws prohibiting the practice of accounting by corporations, principally because of the difficulty of exercising proper ethical control over a corporation wherein the stockholders and directors might not be professional accountants. For all these reasons, it is definitely in the interest of the client and the business community that proper and reasonable ethical rules should be followed by the accounting profession.

This does not mean that accountants should live some sort of cloistered life, nor does it mean that they should not give proper information to prospective clients on the approximate cost of work that might be done for them. It is important for the financial executive to understand this position, and it is for this reason that a description of ethical publicity and proper dissemination of information about accounting work and fees is presented here.

Ethical Publicity and the C.P.A.

Codes of ethics are something like the Ten Commandments, negative and prohibitory. All but two of the commandments are "shalt nots." A C.P.A. may not advertise his capabilities or attainments. He may not solicit engagements. In many states he may not respond to invitations to submit competitive bids on proposed audit or accounting work. He may not pay commissions to anyone who may bring him work. There is, however, some doubt as to whether some of these provisions can be enforced (see Chapter 7, pp. 155 and 156).

Do these prohibitions mean that the C.P.A. should sit, hermit-like, in his office and do nothing but wait and listen for a client to rap insistently on his door? A firm or individual that adopts such a policy may continue to exist for a time, but there will be little or no expansion or development, and dry rot will eventually set in.

There are many legitimate and effective ways for accountants to enlarge their acquaintance and bring themselves to the attention of their fellow citizens as intelligent and public-spirited professional men much like those a lawyer or doctor might use. This applies with equal force to the individual practitioner and the members of local and regional firms and to the partners and employees of the largest firms.

Reaching the Public. In many ways the greatest problem of the C.P.A., apart from the purely technical aspects of his work, is communication, but the methods and means of communication are, properly and definitely, limited by the ethical rules under which an accountant must live. This, however, should not prevent an accountant from reaching a large number of people and impressing them with the idea that accountants are capable, public-spirited, and reliable professional men.

At the local level, especially in smaller communities, membership and work in Masonic lodges, service clubs, churches, chambers of commerce, charities, country clubs, and social clubs, particularly any work the accountant does for the organization that has to do with its financial affairs, is a proper and effective way of becoming known to the community.

Another group of organizations, not composed entirely of professional accountants but accounting-oriented, including such as those of creditmen, bankers, financial executives, and particularly the National Association of Accountants and the Institute of Internal Auditors, provides forums for the discussion of questions affecting the business community and the accountant.

The program chairmen of these groups are always looking for qualified speakers on accounting, taxation, factory costs, business organization, and kindred subjects. The young accountant may participate in discussion groups and so get better known. Most of these groups welcome well-written articles on subjects of current interest. All of this takes time and effort, but it is one of the most effective methods of gaining recognition.

Another group of organizations is that of the professional C.P.A. societies themselves. It is assumed that every C.P.A. who wishes to rise in his profession will be a member of the

American Institute of Certified Public Accountants and of the societies of the states in which he is certified.

Here again the supply of capable writers and speakers is seldom equal to the demand. It has sometimes been said that work in the national or state accounting organizations is little more than accountants' talking to themselves. The best refutation of this is an analysis of the circulation of the *Journal of Accountancy*, the official organ of the American Institute of Certified Public Accountants.

For the month of May, 1966, the circulation was divided among these groups:

Public accountants, practically all members of the A.I.C.P.A.	53,766
Financial and other executives	18,798
Corporate accountants and internal auditors	15,385
Educational institutions and educators	4,291
Accounting students	6,976
Federal and state employees	5,096
Miscellaneous	7,788
	112,100

The *Journal of Accountancy*, the *Accounting Review*, the organ of the American Accounting Association, which is composed primarily of educators in the accounting field, and the publications of the National Association of Accountants provide forums for discussion reaching a far wider audience than the accounting profession alone.

Views of the Profession

The twenty-first question in the author's questionnaire addressed to the cooperating accounting firms (Appendix A) was, "What are your views on ethical public relations: (a) for the C.P.A. firm or practitioner and (b) for professional organizations?"

The answers to this question were more voluminous than to any other. This seems to indicate that it is a question of great concern to the profession. Among the national firms there appears to be some doubt about the nature and limits of ethical publicity, but very little about its desirability if properly organized and controlled.

The regional firms are in general agreement with the need

for ethical professional publicity but are less certain about the means to be employed and the extent of coverage.

The propriety and desirability of the accountant's taking part in community affairs is stressed in several answers.

There is some difference of opinion on the employment by accounting firms of professional public relations advisors, although the general view seems to be guardedly favorable.

One answer, by a partner of a regional firm who has taken a prominent part in the affairs of the American Institute of Certified Public Accountants, including service on the Committee on Professional Ethics, is especially noteworthy. He expresses the views of a member of a small firm who is fully aware of the national situation and at the same time is able to relate this to practice in a small town. His views on the nature and necessity of participation in community and civic affairs and on professional development are highly constructive (see pp. 188–190).

7

Selecting the Proper C.P.A. Firm

CHARACTERISTICS OF ACCOUNTING PRACTICE

For the financial executive to be able to choose the best firm for the task in hand or to decide whether he should rely on any particular firm he should know somewhat more about the profession than is available from present published sources.

The accounting profession, as represented by certified public accountants, is in some respects united and homogeneous. The C.P.A. examination is uniform in all fifty states. There is but one national organization, The American Institute of Certified Public Accountants. There is but one C.P.A. society in any given state. The ethical codes of the A.I.C.P.A. and the state societies are substantially the same and are binding on all C.P.A.'s. All C.P.A.'s giving an opinion on financial statements must satisfy themselves that they are prepared in accordance with generally accepted accounting principles or point out where they do not conform.

About here the resemblances stop and the differences begin. The uniform examination ensures a minimum of technical competence, but for reasons explained in Chapter 6 it can do no more than this.

Whether a particular firm or individual has kept up with recent professional developments and is equipped to give the

services reasonably required by a client can be determined only by individual inquiries. To aid the financial executive in his choice of an individual practitioner or firm, an informal classification based largely on experience and acquaintance in the profession is given here as a guide.

Individual Practitioners

There are many C.P.A.'s who practice as individuals, entirely alone, or with but an assistant or two. Sometimes, particularly in small communities, they look after the affairs of the local businessmen and often build up highly satisfactory practices.

Other individuals, generally in the larger cities, are specialists or experts in particular fields. Many specialize in state or Federal taxation. Since the decision in the Bercu case in New York several accountants, qualified both in law and accountancy, have continued in their tax practice but have done so as lawyers rather than accountants, while other tax specialists have qualified themselves as members of the Bar.[1]

The Bercu case, however, applies only to the State of New York. In most other states accountants are free to give any type of tax advice and the combined practice of law and accounting may be carried on by practitioners who are both C.P.A.'s and qualified to practice as lawyers.

The American Institute of Certified Public Accountants and the various Bar Associations look with disfavor on this sort of dual practice.[2] However, there are many reputable practitioners of this type. They have combined in a society, The American Association of Attorney–Certified Public Account-

[1] New York County Lawyers Ass'n. vs. Bercu—273 App. Div. 524 (1948) 78 N.Y.S. 2nd 209 (1948) aff'd memo 299 N.Y. 728, 87 N.E. 2nd 451 (1949). See also Agran vs. Shapiro 127 Cal. App. 2nd 807 273 P. 2nd 619 (Super. Ct. 1954). In each case the accountant, not qualified as a lawyer, was denied compensation for giving an opinion on a tax question, on the ground that it constituted the illegal practice of law. It was, however, made clear that an accountant could prepare a tax return for a client and represent the client in subsequent discussions with the Internal Revenue Service. As a practical matter these decisions had little effect on the tax practice of most accountants.

[2] W. D. Sprague and Arthur J. Levy, "Accounting and Law: Is Dual Practice in the Public Interest?" *Journal of Accountancy*, December 1966, p. 45.

ants, the president of which has written a description of this type of practice.[3]

Other accountants have specialized in consolidations, mergers, joint ventures, and similar transactions where broad experience and judgment as well as technical knowledge are essential, but where a large staff is not necessary. Still others have become real estate specialists, working on the intricate problems of finance and taxation involved in large real estate transactions.

There are many similar fields where the individual practitioner can render most valuable service. It is not unusual for such a man to be called into consultation on a particular problem by the regular auditors. Such men are generally well known in their particular field, and inquiries of the executives of companies operating in the field or of banks will usually enable the prospective client to get in touch with them.

Except where small local businesses are concerned, the position of the individual practitioner attempting to render all necessary accounting services to his clients is becoming increasingly difficult because of the ever-growing scope of professional accounting work, as indicated in Chapter 1. Even in a firm with only a few partners it is recognized that no one partner can cover everything. This is true whether the firm is formally departmentalized or not.

Local Firms

Local firms are those that practice in one city or neighborhood, usually from one office. They vary in size but seldom have a large staff. An organization of fifty people would be unusual; generally, they are much smaller. These firms usually have a large part of their practice in one industry, and some at least of their partners are well acquainted and familiar with the operating and economic aspects of the industry as well as its accounting and financial problems.

Good examples of such firms are those in New York City

[3] Louis Goldberg, "Dual Practice of Law and Accountancy: A Lawyer's Paradox," *Duke Law Journal,* Vol. 1966, No. 1.

that have as clients members of the fur and garment industry. Although the problems are in principle no different from those of any other business, there are certain conditions that a newcomer to the industry would find it difficult to deal with, lacking specific experience. Among these are inventories, particularly where questions of style obsolescence are involved. Statements, not necessarily complete, are sometimes required monthly or quarterly by banks, as this industry relies heavily on bank credit. The relations between banks and accountants are close, and the standing of the accountant with the banks serving the industry is of great importance to the client. There are certain statements and statistical reports required by union agreements that the accountant must prepare and certify. The accountant works in close cooperation with his client.

All this is in addition to the usual tax and audit work. The criterion by which to judge such a firm is its skill and standing rather than size.

In the Southwest a similar situation prevails with smaller operators of and investors in petroleum properties. There the tax features are probably the most important, and a local firm specializing in the field can render most valuable service, regardless of its size. A knowledge not only of the taxing statutes and regulations but also of actual local practice and conditions is essential. Furthermore, continuous preoccupation with similar problems makes for speed, certainty, and economy in their solution.

A local firm in a Western city has developed a highly successful and remunerative practice taking care of the tax and financial affairs of doctors, dentists, and similar types of professional men.

These are only a few examples of what local firms can do. They are generally expert in the industries of their city or neighborhood and can be relied on to serve local individuals and local industries well.

Regional Firms

These are firms with offices covering one region of the country, the Southeast, the Southwest, California, the Northwest or Midwest. In general the regional firm is found in sections

not dominated by one or two large cities, but there are many exceptions to this.

The typical regional firm will have several offices in the important centers of the region, particularly in the towns and cities where the dominant industry includes a large number of the firm's clients. It will frequently have an office in a large city where some of its clients have selling, purchasing, or financial connections.

For example, a regional firm in the Southeast might have offices in North and South Carolina, Georgia, and Virginia. Its clientele might be largely in the textile industry. Such a firm would probably have an office in New York as some of its clients, particularly those publicly owned, would have many financial, selling, and purchasing connections in New York that could be better served by a branch office of the regional firm than by a correspondent.

A firm in the Southwest might have as clients a number of agricultural cooperatives and Rural Electrification Authorities. It might also take care of the tax and financial affairs of a number of ranchers, cotton growers, and citrus fruit enterprises. Such a firm, in addition to its regional offices, might well have a Washington, D.C., office or a correspondent there with whom it would work closely.

It is almost always possible to find, skilled in the principal industries of the region, a regional firm that has the respect of the various state and Federal authorities with which it has to deal.

Some of the regional firms are organized departmentally on the general pattern of the national firms, and others are not. Any progressive regional firm, however, should be able to perform or arrange for the performance of practically any accounting service, and the financial executive should not assume that because a firm is not departmentalized it is not equipped to render the services its clients need.

The answers of representative regional firms concerning their organization and abilities (see Appendix A, pp. 172 and 173) may be taken as a guide to the inquiries the financial executive should make when deciding, first, whether he will be best served by a regional firm, and second, which particular firm will best serve him.

National and International Firms

When national and international firms are discussed those that first come to mind are what are frequently called the "big eight." These firms have offices in every large city and many of the smaller cities in the United States and offices, associated firms, or correspondents in practically every part of the free world. There is another group of national firms somewhat smaller than the big eight but with offices covering the United States and generally with foreign associates or correspondents.

Most national and international firms disclaim any type of specialization but state that they are prepared to undertake any engagement within the accounting field. The general organization of these firms is much the same for all. They have departments for audit and investigations, taxation, SEC work, and management advisory services. Some have departments for regulated utilities.

Some of the second group of national firms are specialists in particular industries—for example, in hotels, clubs, and motels; in furniture manufacturing; or in retailing and department stores.

These firms, as well as the international firms, are sometimes able to prepare statistics for the entire industry that are not only valuable to the members of the industry but give the auditors a standard or scale against which to measure the performance of individual enterprises.

Although there are many types of service that a national firm or a regional firm can perform equally well and (in many situations) there may be good reasons why a local or regional enterprise might prefer a regional firm, there are certain circumstances in which the necessary services can be obtained only by utilizing the resources of a national or international firm.

Every national or international firm has numbers of smaller enterprises among its clients who receive the full benefit of its diversified capabilities. To a considerable extent the growth of the large firm is aided by the growth of its smaller clients.

The growth and development of the international accounting firm has gone forward step by step with the growth of the large industrial and financial corporation. The foundation of

the practices of what later became the international firms was in the basic industries that were formed into large enterprises in the early part of this century. Among these industries were iron and steel, railroads, meat packing, and breweries. The accounting firms grew to meet the demands of their early clients.

When new industries began to develop on a country-wide and sometimes a world-wide scale the executives, the financiers, and the bankers looked to the accounting firms with a number of offices in this country and with foreign connections, either as parents of the American firms or as their correspondents or associates, to give them the services they needed. At that time foreign investment in American business was still heavy, and it was a distinct advantage to have auditors known and respected in Great Britain and the rest of Europe. The financial executives of the developing and emerging industries, where these were national or international in character, could be satisfactorily served only by an accounting firm of the same scope.

These firms made a great and generally successful effort to keep up with or perhaps anticipate the demands made on them by the public utility, the petroleum, the electrical manufacturing, the agricultural implement, the automobile, and the chemical industries, to name only a few.

In the present time of revolutionary technical changes; increased investment abroad; intensive development of home markets; increased involvement with government as regulator, tax-gatherer, and customer; and increasingly severe foreign competition the financial executive of a national or international enterprise must look to the same type of firm for his accounting advice and service.

Group Practice

A comparatively recent development brought about by the requirements for local or regional firms to extend their practices both in added services and in their geographical coverage is what is known as "group practice."

Something of this sort was attempted some thirty or more years ago, when a number of local and regional firms, keeping their own identity, also became members of an overriding na-

tional firm in whose name audits could be made and by whom financial statements could be certified. In spite of the obvious advantages of combining the forces of local and regional firms, the administrative difficulties of attempting to practice in effect as a local office of a national firm and at the same time as an independent regional or local firm proved insurmountable.

There were other reasons for the abandonment of this form of group practice, but it seems clear that the attempt of a number of actually independent firms to gain the advantages and prestige of a national firm without at the same time adopting the appropriate organization and control was the real reason for the dissolution of the overriding firm.

Nevertheless, the idea of group practice is an interesting and challenging one. While it has not yet reached its full development (the oldest group now operating was organized as recently as 1957), it may provide solutions to some problems of the profession that will be of benefit to the small and medium-sized firm and particularly to their clients.[4]

Group practice, as at present carried on, seems to have avoided the difficulties inherent in the overriding firm concept. At the same time, the actual control of standards within the group and the effective utilization of the skills and capabilities of the member firms have been achieved through a rational and flexible type of organization.

Many of the advantages of a large firm have been realized by the group. Recruiting of staff has been done on a group basis. The small firm has always been at some disadvantage in recruiting, and the presentation of the larger opportunities in group practice has undoubtedly influenced recent graduates in their employment decisions. The group maintains a central administrative office with a full-time executive director and staff and is further assisted by distinguished accounting authorities who act as consultants in the preparation of practice manuals and in similar matters.

The group holds meetings and seminars at which various

[4] A more detailed account of the operation and aims of group practice may be found in I. H. Krekstein, "How Local Firms Can Help Each Other," *Journal of Accountancy,* August 1962. The author is a partner in a firm that is a member of such a group.

matters of professional interest are discussed, including Federal taxes, staff recruitment and training, management advisory services, and computers, as well as basic accounting policies and principles. Statements of group policy are issued for the guidance of group members, and a newsletter for the information of members is issued monthly.

A comprehensive catalog or index of the skills and capabilities not only of the member firms but of the individual partners is maintained. This is a means of pooling the resources of the member firms. The result is somewhat the same as that obtained when different offices of a large firm are able to assist one another in work requiring special qualifications or the use of special staff.

The method of organization, described by one group as "an unincorporated association," is flexible but not loose. Firms desiring to join the group must submit to a complete and thorough examination and are admitted by unanimous vote only. A program of inspection of member firms to ensure that high and uniform standards are maintained is also in effect.

Membership of United States firms is limited to those whose partners are members of the American Institute of Certified Public Accountants and their appropriate state societies. Other provisions require qualifications of foreign member firms to be substantially equal to those of United States firms. A firm may be expelled from membership by a majority vote of the member firms with no specific reason given.

The group works in close cooperation with the American Institute of Certified Public Accountants and the state societies. Partners of member firms are active in the national and local accounting organizations, acting as officers, council members, and committee chairmen of the A.I.C.P.A., and as well fill similar positions in their state societies. The group is in no way competitive with these organizations.

The problem of a client's "outgrowing" the accountant who served him when he was small and struggling may be solved by pointing out that the client has at his command the capabilities of the entire group, without, at the same time, losing the personal touch of the accounting firm he has long been accustomed to.

WHAT THE CLIENT SHOULD EXPECT FROM THE C.P.A. FIRM

The client is entitled to expect from the accounting firm chosen to do his work three things: integrity, competence, and objectivity.

Integrity

Integrity is the first requisite. Without complete integrity the most brilliant abilities and skills are not only worthless but may even be dangerous. Integrity does not consist in never making a mistake or in never being deceived. Although there may be some opinion to the contrary, accountants are only human. Integrity does consist in never consciously acting improperly, unfairly, or dishonestly and in refusing knowingly to yield to improper pressures or influence.

CASES AGAINST ACCOUNTANTS. Many accountants have been accused of various types of negligence and wrongdoing, and some cases have been decided against the accountant and some have been settled out of court. Can a client or prospective client rely on the integrity of the accountant against whom a decision has been given or who has made an out-of-court settlement?

Cases against accountants fall into three classes: first, where error, inadvertence, or negligence has caused or permitted loss to third parties; second, where failure to detect fraud, embezzlement, or other irregularities results in loss primarily to the client and secondarily to a bonding company or other guarantor; and third, where the accountant himself is accused of intentional unethical acts, misconduct, or even criminal acts.

Negligence Cases. Deplorable as the results of the first two types of cases may be, no moral stigma attaches to the accountant for what may be termed sins of omission, in which no one can doubt the accountant intended to do an adequate job and wanted to present complete and correct statements as the result of his work. His professional reputation might suffer and his competence might be questioned but he could not fairly be held to have committed any act involving moral turpitude so long as it was a misfortune, unintended and inadvertent, and

the accountant stood to gain nothing from the failure to discover or disclose the errors and inadvertencies.

Third-Party Liability. In one of the first important cases involving accountants' liability to third parties, Ultramares Corp. vs. Touche, et al., it was held that there could be something like fraud, but not quite fraud, where negligence was involved: [5] "The defendants owed to their employer a duty to make their certificate without fraud, and a duty growing out of the contract to make it with the care and caution proper to their calling. Fraud includes the pretense of knowledge when knowledge there is none. To creditors and investors to whom the employer exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself."

This is a fine distinction and actually was made to limit the accountant's liability, but it is still true that what is under consideration is the result of inadvertence or misfortune, and whereas it certainly has some bearing on a firm's competence and professional reputation, it has none on the firm's moral integrity.

These exposures to liability are inherent in the practice of accounting. No matter how carefully an accounting staff is trained and selected, there can hardly fail to be at some time a staff member employed who is not fully competent, or a staff member ordinarily competent who may be suffering in health or under some other strain that may cause him to make errors of omission or commission he would not otherwise have made. The firm is responsible for the errors of the staff and, to a considerable extent, every representative of the firm holds its reputation in his hands.

Internal Frauds, Defalcations, and Embezzlements. Cases where the accountant is held liable for failure to discover internal frauds or irregularities do not usually attract the attention that cases involving third-party liability do. The amounts involved are generally smaller, and in almost all such cases the question of contributory negligence on the part of the client

[5] Ultramares Corp. vs. Touche, et al., 229 App. Div. 581, 243 N.Y. Supp. 179 (1st Dept. 1930) reversed in 255 N.Y. 170, 174 N.E. 441 (1931).

is raised. The financial executive and the accountant should have a clear understanding of the responsibility of the independent auditor for the detection of fraud and particularly of the extent to which the independent auditor may rely on the work of the internal auditors and on the effectiveness of the system of internal control.

Unheeded Warnings. A series of warnings, disregarded by the management of the client, is either a defense against a charge of negligence or, if conditions become so bad that the company's financial position is affected, a reason for a refusal to give an opinion.

Every experienced accountant can think of instances of disregarded warnings. In the case of a wholesaler the physical layout was such that pilferage of valuable and easily portable merchandise was almost impossible to detect. When this was discussed with management, it was agreed that conditions were bad but management contended that it would cost more to correct them than the estimated pilferage loss. The warning was repeated year after year until the company moved to a new building where conditions made protection against pilferage possible. The accountant was protected and considered that the pilferage under the former condition was a business expense, contemplated and provided for by the management.

In another case in a processing industry repeated warnings that the processing losses of the client were a much higher percentage of material put in process than prevailed in the industry as a whole were disregarded by the management. A new management took active steps, including the employment of private detectives, to find out why the losses were disproportionate and discovered that large amounts of good material were marked waste and diverted to another manufacturer with whom employees of the client were in collusion. Here the new management, instead of holding the accountant responsible, expressed appreciation of the repeated warnings and regret that they had not been acted upon earlier.

Many examples of unheeded warnings and subsequent loss could be given, as well as many more of frauds discovered after they had been going on for a longer time than seemed warranted in the circumstances.

DETECTION OF FRAUD. The financial executive should recognize that internal fraud and misconduct, from conflict of interest between officers as individuals and the company that employs them down to the office boy who steals a few stamps, are not exceptional or isolated instances of human depravity. While it is not true that every employee is a potential defaulter or embezzler, many employees fall potentially into these categories.

Auditing, external or internal, and all the various devices of internal control recognize this. In order to avoid the difficulties and embarrassment of singling out specific individuals for suspicion and investigation, the same controls and checks are applied to all.

A payroll system is devised to minimize any possibility of "padding" with non-existent employees, of juggling with unclaimed checks, of collusion between the pay office and employees to "raise" checks above the authorized amount, and all the other fraudulent devices that might be used on this important disbursement. These precautions are not taken because fraud is a remote possibility. These controls are installed because the name and place of a potential defaulter or embezzler are unknown.

It is the same with the purchasing, warehousing, and issue of materials and supplies, the control of scrap and process losses, inventory "markdowns" for obsolescence, and inventory "losses" and "shortages."

The truth is that just as many of the inhabitants of any town are potential lawbreakers, restrained by the law enforcement agencies, so in the same way many employees, and sometimes even the officers of a company, are potential defaulters and embezzlers restrained by the knowledge that effective controls of various types are in operation.

The financial executive should expect his independent auditor to be aware of the proper controls for his business and should cooperate with the independent auditor to make them effective. He should not blame either his own internal auditor or his independent auditor for failure to discover every fraud as soon as it is attempted.

WHEN FRAUD IS DISCOVERED. When frauds are discovered the first step is either to punish the defaulter and recover, from

a surety company or otherwise, as much as possible or, in some exceptional cases, to put the defaulter in some position where temptation is removed and endeavor to rehabilitate him. Action of this sort may sometimes be dictated by a feeling on the part of the employer that his own laxness had contributed to the employee's misdoings. The second step is a comprehensive reexamination of the controls and auditing procedures that allowed the fraud to take place.

Perhaps what all this should mean to the financial executive is that, while the ethical standards of professional accounting are high, he should not assume that they are invariably observed but should make some inquiry himself about the accounting firms with which he deals or on which he must rely and should form his own opinion of their reliability and integrity.

Competence

The client is entitled to expect his certified public accounting firm either to be able to meet all his accounting needs and such of his technical or organizational requirements as fall within the proper, now greatly expanded, scope of public accounting work, or to be able to make arrangements for some other firm or organization to do what the firm serving the client is not equipped to do.

This is a simple statement of a most complex situation. There are problems of communication involved for both businessman and accountant. The executive or businessman on the one hand frequently does not know what his accounting, statistical, and organizational needs really are, and on the other is unaware of many of the services that he can and should expect from his accounting advisors.

The individual accounting firm is not permitted under the ethical rules of the profession to describe to the public the various services it can render or the different fields in which it has some special competency. There are, however, no ethical rules to prevent making the capabilities of an accounting firm clear to its present clients. The writing of books and articles and the presentation of papers on the scope of the accountant's

work in general are valuable services to both business and the accounting profession.

Ability of Partners. In judging the competence of an accounting firm the first consideration is the ability of the partners. Generally, a man's rise to partnership in a substantial firm, large or small, is a good indication that he is not only technically proficient but that he is a good organizer, a sound businessman, and something of a diplomat and manager of men as well. While accounting is a profession, there are also basic business principles in the operation of an accounting practice that must be followed if the firm is to exist. The most brilliant professional work will not overcome the effects of overstaffing, excessive overhead, ineffective employment and recruiting policies, and careless or inefficient time recording or billing practices.

The mere fact that a firm has been in practice fifteen or twenty years is evidence of reasonably good internal management and that the partners are good, practical businessmen as well as capable technicians.

Competence of Staff. In general the accounting staff of a firm at the present time will be composed of college graduates eligible to take the C.P.A. examinations on completion of whatever experience requirements are in effect in the state in which the firm practices, qualified men and women of several years of experience who have not yet passed their examinations, C.P.A.'s, and frequently some specialists such as engineers, statisticians, and mathematicians in the management advisory services department.

A firm wherein a high proportion of staff is not qualified to the extent indicated should be investigated thoroughly and required to prove that it is competent to render the highest type of service.

Although it is not true now to the extent it was some years ago, some firms specializing in stock brokerage or insurance company audits have had large staffs of comparatively low-paid men qualified for work in those fields only. The use of more and more mechanical means of record keeping is eliminating the type of detailed auditing for which such a staff was required.

Rotation of Auditors. While there is not so much heard of it now as in the recent past, the advantages of or the purposes to be served by employing different firms of auditors each year or at longer intervals has been rather widely discussed. Occasionally an agreement, trust deed, or some other controlling document requires this. Where rotation had been adopted voluntarily as a company policy, it is falling into disuse.

The objectives of rotation of auditors are useful and legitimate, although experience indicates that they can be gained by other means than the periodical substitution of one firm for another.

The advantages of rotation are most evident at the level of the actual field work. Although the entire staff on an audit should not be changed every year, changes will always take place, and every change should provide a fresh look at some part of the work.

In a large or even a medium-sized firm, most of the advantages of rotation are present. The firm must keep up with current ideas in accounting. Most firms have a partner whose duty it is to develop and formulate firm policies on new or controversial accounting questions, and it is unusual for accounts of any importance to be issued without consideration by some partner other than the one in charge of the work.

The disadvantages of what we might call complete rotation, the substitution of one firm for another, are principally the loss of the services of partners and staff intimately familiar with a client's affairs, the additional time required to familiarize the new firm with the essentials of the client's affairs, and the disruption and inconvenience the client's organization suffers, which generally more than outweigh any possible advantages of this type of rotation.

The principal advantage of continuity in audit work is the increased value of the accountant as a consultant. This grows with his knowledge of the client's affairs and problems. The possible danger, where one accounting firm works for one client for many years, is that the accountant will become so involved with his client that he loses his perspective. Long acquaintance with management might make the accountant susceptible to pressures and inclinations of which he is hardly aware. Close

personal relationships between the management of a client company and the accountant might develop. The answer to all these objections is that if the accountant understands his professional position, he will not allow such conditions to exist. Even with individual practitioners or quite small firms, it is possible to keep up with the developments in the profession and in the client's industry and thus assure a fresh point of view.

Recruitment and Training Policies. The financial executive is entitled to know in a general way the composition of the accounting firm's staff, its recruitment policies, and the standards it sets for its employees.

Regardless of state C.P.A. requirements, it is unusual at the present time for a young man to attempt to enter the profession without at least an undergraduate degree in accounting.

Although a C.P.A. degree is desirable whether the holder is intending to practice public accounting or not and public practice is generally regarded as the best type of accounting experience, it is nevertheless true that in a relative sense public accounting experience is not as highly regarded as it once was.

Even in Great Britain, where forms of apprenticeship still exist, the parents of young men wishing to become chartered accountants not only do not have to pay substantial "premiums" for the right to work as an apprentice for three to five years, but young men who aspire to become chartered accountants receive a reasonably adequate salary from the beginning of their employment.

In this country, although there was never any type of formal apprenticeship, young men in the not so remote past would gladly accept salaries well below the going commercial levels for the opportunity of gaining experience and fulfilling the requirements for taking the C.P.A. examinations. This has not been true for some years. The demand for graduates in accounting has increased tremendously, much faster than the supply.

Industry, the United States Government, particularly the General Accounting Office, the Internal Revenue Service, and some sections of the Defense Department; and civilian pro-

fessional and service organizations other than public accounting firms have competed vigorously for each year's crop of graduates.

Salaries and Fees. The result has been a progressive rate of increase in starting salaries, which has in turn affected salaries generally in the profession. Much of the increase in accounting fees measured as hourly rates in the last few years has been for the accounting firm merely the turning over of dollars with a negligible proportion of the increase remaining as firm profits.

The financial executive cannot hope for lower hourly rates. Accounting fees may, however, in many cases be kept within reasonable bounds if there is adequate cooperation between accountant and client, as explained in detail in Chapter 4, page 78, and the client makes use of all applicable modern safeguards and controls.

The experience with starting salaries of regional and national firms that kept generally to the standards of recruitment described earlier in this chapter was for the years from 1957 to 1966 as follows:

Year	Average Starting Monthly Salary
1957	$407
1958	423
1959	440
1960	461
1961	491
1962	516
1963	542
1964	552
1965	573
1966	606

The exceptional man might receive $50 or more per month above the average. There were no significant differences between the regional and national firms that furnished the information on salaries. Salaries of specialists of various types would generally be somewhat higher than those of accounting graduates.

These are the requirements for recruiting a really competent staff. As always, high salaries intensify the search for better

methods. This is particularly important in accounting where the supply of first-class staff is not equal to the demand. The difficulties this causes are felt by all firms, large and small, and it is hoped that some of the suggestions in this book (Chapter 4) may do something to make the use of the potential at the disposal of the profession more effective and valuable.

Physical and Mechanical Equipment. While an inquiry into the quality of the partners and staff is the predominating and determining test of competency, it is also necessary for the physical and mechanical equipment of the firm to be considered. The number and distribution of branch offices in the United States and abroad may be most important for some types of work. Ownership or access to electronic equipment may be important. Access to research material, particularly for the small firm, may be necessary. It is assumed that any modern accounting firm, large or small, would be adequately supplied with calculating and adding machines, copying and multigraphing equipment, and the like.

Objectivity and Independence

As the greatest volume of work done by the professional accountant is recurrent audit work it is only natural that the requirements for objectivity and independence should focus on that field and on statements on which third parties are entitled to rely. An audit is a critical examination of a set of financial statements and the underlying books and records from which they are prepared. Anyone who relies on a critic, whether of music, painting, stagecraft, or financial reporting, does so on two assumptions: (1) that the critic is competent to appraise and evaluate what he is reporting on, and (2) that he is giving an honest opinion, uninfluenced by personalities, rewards, or threats.

This is the position of the auditor. He must not only be independent (as a matter of a subjective state of mind), but he must also be careful to look independent, to preserve certain appearances, to perform certain ritual acts and observances. This may, at times, seem petty and annoying, but it is quite probable that if it were not insisted upon abuses would gradually creep in.

Ownership of Client Company's Securities. A clear-cut prohibition, for example, of ownership of any securities of a client firm would have no real significance if a partner of a national accounting firm owned one hundred shares out of ten million in a corporation, of which his firm was the auditor, listed on the New York Stock Exchange. But if an accountant owned ten or twenty per cent of a small, closely held corporation, it might have a considerable influence when he was preparing statements for a bank or other creditors. Basically the rule against ownership of client securities is correct, and the worst that can be said against it is that it occasionally produces faintly ridiculous results.

Participation in Management. Another and much more serious test of independence is whether the auditor is in any way involved in the management of a client. The danger to independence if the auditor is a director or officer of a client company is obvious. Few if any human beings can criticize their own work effectively, which is what an auditor who is also a director or officer would be trying to do.

There is, however, a much more insidious danger to independence that arises primarily through the development of management advisory services but may be present in a great deal of other consulting and advisory work.

Perhaps the greatest single problem of the accountant is to maintain an independent and objective attitude and at the same time do everything in his power to assist the client both in the operation of his own business and in his relations with third parties. For the audit function alone, this is not so difficult. In taxation the accountant has statutes, regulations, and rulings to go by, and in disputes with the Internal Revenue Service he is merely discussing interpretation. He is of course acting for the client, but he is not identified with the controversy as a principal.

Another example where management advisory services stops and management decisions begin might be in marketing and distribution. Customer or market potentials might be investigated and the possible results of the introduction of a new product forecast or estimated without loss of independence or objectivity, but if the accountant in the management advisory

services department were asked to decide whether the new product should be introduced at all and in what markets, he would cease to be an independent advisor and would become part of the company management.

An accountant's statements often indicate to management the results of a specific policy or course of action but may also present two or more alternative solutions to a problem. For example, in a "make/buy" question, the answers may project the results of making all components, buying all components, and several mixed solutions where differing proportions of components are made and bought. The accountant can hardly fail to have an opinion as to which solution is most advantageous to the company. He must, however, carefully refrain from advising or recommending any basic policy decision. If a course of action or a policy is adopted as a result of his recommendation, he becomes responsible for it and he is taking part in management, which he can no longer criticize objectively.

Every change or development in the operation of an enterprise involves a recommendation and a decision. Some are major and some minor, some are external and some internal. In general the accountant cannot become responsible for major external decisions without loss of independence, but neither can he do his work without making or influencing many internal decisions, some of great importance.

While the final decision is the client's in carrying out the recommendations as to what accounting machinery, tabulating equipment, or computer to use, the responsibility is often and properly placed on the accountant.

The accountant may carry out organizational changes, make assignments of duties, and even evaluate accounting personnel and certain classes of management personnel without loss of independence. These lie within his particular province, and he can accept this type of responsibility.

He may also make minor or subsidiary decisions on external matters. If the management advisory services department of an accounting firm is making a sales and marketing study and it is discovered that salesmen in certain regions are giving unauthorized discounts or allowances, the accountant would suffer no loss of independence in correcting these conditions

on the spot rather than by making a recommendation and waiting for a management decision.

However, a decision to revise the rates of discounts or the conditions for allowances, say for promotion and advertising, could only be made by company officials. If the accountant made such a decision he would be acting as a company official, not an independent public accountant.

The management services man, unlike the industrial engineer who is not concerned with independence, must practice a difficult and trying professional funambulism if his firm is to be both auditor and management advisor to the same client.

Many times the line between rendering a service or making a report on which a company official acts and making the decision itself seems somewhat vague, but if it is constantly borne in mind that influencing a decision does not mean a loss of independence or objectivity but making the decision does, these questions will clear themselves up.

Value of Independent Criticism. The financial executive should be satisfied not only that his accounting firm observes the letter of the law so far as independence is concerned, but also, much more important, that the firm is genuinely independent and is so regarded by the financial community.

Independent criticism may not be palatable to a client at all times, but the financial executive may rest assured that auditors do not criticize clients lightly or without a good deal of soul-searching. No accountant wishes to annoy or antagonize a client if it can be avoided. He must be absolutely sure of his ground when making criticisms. There is always the feeling that the client may, perhaps, know more about his own business than the accountant.

There are risks in making unfavorable criticisms, but these risks the accountant must take if his work is to be fully effective. These criticisms are probably the most valuable single service of an auditor and certainly the most difficult for him to render.

What the Independent C.P.A. May Not Do. In general, there are certain things the accountant may not do and still remain independent. Among these are:

1. Possess a financial interest in a client.
2. Accept without verification the statements of an accountant not a C.P.A. or not qualified in an equivalent manner in his own country.
3. Render an unqualified opinion on financial statements without having made an audit based on generally accepted auditing standards.
4. Act as officer or director of a client company.
5. Accept or demand fees contingent on the results of his findings, except in tax work where the true findings are those of a third party, the Internal Revenue Service.
6. Make brokerage or commission agreements with non-C.P.A.'s.
7. Engage in any occupation incompatible with public accounting.

These are covered, explicitly or implicitly, by all codes of ethics for accountants. Basically they may be reduced to two simple maxims: a man cannot serve two masters; neither shall he lay claim to work he has not done.

The management advisory services department should be so organized that communication with other departments is sufficient to prevent any conflict with reports or opinions for which the firm is responsible.

GETTING TO KNOW ACCOUNTANTS BETTER

In the old, established corporation of national or international scope the financial executive is seldom in the position of influencing the choice of the auditors by the directors or occasionally the stockholders. He should nevertheless make careful inquiry into, first, the full capabilities of his auditors, and second, whether they are keeping up with the changing standards and requirements of the profession.

Judging from the answers to those parts of the questionnaire (Appendix A) dealing with the awareness of clients of the auditor's special capabilities, it is the view of the majority of accountants that even present clients are not fully aware of what the accounting firm can do for them.

The financial executive, whether his auditors are a regional, national, or international firm, should make a point of meeting

the partners in charge of management advisory services, of tax practice, of SEC work and other work for regulatory bodies, of government contract and other work connected with the Defense Department and with the executive departments of the government.

Management Advisory Services

The financial officer may be somewhat surprised by and should be interested in what can be done for him by computers and other electronic equipment. In this day of rapid change it is hardly safe to rely on the written word alone about these new developments, as there must be a substantial time lag between the devising and operation of new methods or processes and their description in an article or book.

The men in charge of the management advisory services department of a progressive accounting firm are frequently in the position of the leaders of the profession in the early part of this century: they are not choosing from several tried and approved methods to fit a particular situation, they are creating new solutions to new problems by changing and developing means. Personal contact with the men on the firing line is the only way to be sure of getting the best service currently available.

Tax Practice

It is a general rule in most firms for a tax partner or principal of the firm to have a more intimate and up-to-date acquaintance with the client's problems than can be obtained by merely preparing tax returns and fighting contested assessments.

A capable tax man generally has a wide acquaintance with others in the tax fraternity: accountants and lawyers in tax practice, and corporate officers and employees responsible for the tax affairs of their companies. Typically they belong to various formal and informal groups, in addition to accounting societies, such as the Tax Executives' Institute, the Tax Forum, the tax sections of the American Bar Association, tax societies connected with or under the guidance of the universities and law schools, and the various tax institutes held in almost all parts of the country.

At these meetings tax men talk to each other in a cryptic, abbreviated language where numbers of sections of Revenue Acts, regulations, rulings, and treasury decisions largely take the place of descriptive words. They have no difficulty, however, in translating this dialect into comprehensible English for the benefit of their clients. They not only keep abreast of current events but frequently are able to foresee developments in legislation and administrative policy.

There are several advisory committees to both the Treasury Department and the Internal Revenue Service where the advice of these men is sought officially, and it is an everyday occurrence for their advice to be asked unofficially.

For all these reasons it is of the utmost importance for the financial executive as well as the head of his tax department to know and keep in reasonably close contact with the tax partner of the accounting firm responsible for the company's tax work.

Work with Government Agencies

The partner in charge of SEC work will typically be acquainted with the members of the Commission staff. He will be able to forecast the attitude of the Commission on various questions with much more accuracy than can be arrived at from published statutes, rulings, and releases.

Common sense and a spirit of reasonableness when dealing with reputable people are characteristic of the Commission. There are generally grey areas in every registration of securities. An experienced SEC man knows where these are likely to occur and what to do about them. An informal visit with the staff will often clean up, in a few hours, what could take days of time and reams of correspondence by more formal methods. The SEC partner is a good man to know.

In the same way the partners particularly experienced in dealing with other government agencies can indicate the course of action most likely to be acceptable. What can successfully be demanded and what is likely to be contested can be anticipated from experience in similar situations, and much time saved.

With government contracts the time to avoid disputes is when the contract is being drawn up, and the accountant can

be of great service in drafting or evaluating the financial and cost sections.

Foreign Operations

If the company has foreign operations of any sort, the partner in charge of the accounting firm's operations outside the United States should be fully informed about them. The financial executive should not only discuss present operations and policies but should also give as much information as possible about the future.

The accounting firm, through its foreign offices, will be well informed on many features of doing business in any particular country. Among other things taxation, exchange situations including repatriation of capital and remission of earnings to the head office, foreign staff and the hiring of the country's nationals, certain phases of labor relations, and the recommendation of local legal counsel may be among the important things on which the particular foreign office may be of assistance.

The financial executive can hardly spend his time better than in getting acquainted with the partners of the firm that does the audit of his company, the men who are responsible for the various financial, tax, system, and cost aspects of its operations.

SELECTING AUDITORS FOR A NEWLY ORGANIZED OR ACQUIRED ENTERPRISE

The selection of the accounting advisors for a newly organized enterprise is often a matter of some difficulty. Personal acquaintance of some of the officers with a particular firm and its general reputation should all be given full weight, but none of these takes the place of a careful investigation of the capabilities and connections of any accounting firm by the financial executive. Many features of the new enterprise need to be considered:

1. Is it local, regional, national, or international in scope?
2. Are its customers the general public, other industries, or some branches of the United States government?

3. Are its securities registered on an exchange under the jurisdiction of the Securities and Exchange Commission?
4. Is it financed by all or some of these methods?
   - Common stock
   - Preferred stock
   - Debentures, convertible or not
   - Bonds
   - Short-term bank credit
   - Long-term credit extended by lenders such as insurance companies or pension or other trust funds.
5. Does it have tax problems peculiar to the industry, such as the treatment of percentage depletion, exploration and development costs in the extractive industries?
6. Does it have foreign operations, subsidiaries or branches requiring the solution of problems such as the treatment of foreign exchange, repatriation of capital, and remitting income to the United States?
7. Is the industry or any part of it under the supervision of such governmental bodies as the Interstate Commerce Commission or the public utility commissions of some of the various states?
8. Will the solution of problems connected with manufacturing costs, sales statistics, distribution costs, the evaluation of new projects, and the introduction of new product lines be of major importance?

These are by no means all of the questions the financial executive should ask about the new enterprise and on which he should be satisfied before engaging an accounting firm, but they should act as a guide to what ought to be considered.

Much the same considerations apply to an enterprise newly acquired by the company in which the financial executive is an officer. Generally speaking, the parent company's auditors will take over the work of the newly acquired subsidiary, but if it operates in a line of business unrelated to that of the parent or in a foreign country the employment of a firm familiar with the new industry or practicing in the foreign country should be considered. The disadvantages of such an arrangement, however, generally outweigh its advantages. The most desirable situation is for one accounting firm to be responsible for all the accounting work for any one client.

"PROPOSALS" FOR ACCOUNTING WORK

Once the accountant is approached by a prospective client he is free to make any truthful representations about his capabilities and experience. The prospective client is entitled to know what services he may expect and to receive enough information about the organization and facilities of the accounting firm to form an opinion as to whether the services will be satisfactorily rendered.

If the information is not volunteered or if it is incomplete, it is the financial executive's duty to satisfy himself by further questioning, although in a well-organized accounting firm this is seldom necessary.

The financial executive is also entitled to know, within reasonable limits, approximately what the contemplated work will cost his company. These estimates generally take the form of "ranges." For example, a new audit may be estimated to cost between $8,000 and $10,000 a year, or the cost of the necessary work on a new security issue may be estimated to lie between $35,000 and $40,000.

It is usually stated by the accountant that these figures are estimates and that the actual billings will be based on the time of partners and staff required to complete the work. This will give the financial executive enough information to present the situation to his Board of Directors or to the responsible executives.

These proposal letters or memorandums may run from one or two pages, where the work is for a small company or where the executive to whom they are addressed is well acquainted with the firm, and to fifteen or twenty pages for a large, new client with branches or affiliates spread over a wide area in this country and abroad. Some representative proposal letters are given at the close of this chapter. The essentials to be covered are:

A description in general terms of the work to be done, including in audit work reference to the extent of the reliance of the independent accountant on the internal check and the internal audit staff of the client.

A description of the facilities and capabilities of the firm covering audit, tax work, Securities and Exchange Commission work, and management advisory services. Where pertinent the location of domestic offices could be given as well as a description of the services that might be rendered by foreign branch offices, affiliates, or correspondents.

If the firm has partners or staff especially qualified in the business or industry of the prospective client, this would be pointed out. If pertinent, the partner who would be responsible for the work might be named.

An estimate of the probable fee, within a fairly wide range, would be given, carefully qualified to cover emergencies that might arise, either in audit or management service work, and making it clear that work additional to that contemplated would require an additional fee.

A proposal letter for a large international corporation and its subsidiaries and affiliates would require much more detail. Such a letter, no matter to whom addressed, is really meant for the board of directors and the principal executives of the company. It would cover in addition to the information just outlined the number and location of offices; a description of special services in foreign countries; a list of prominent clients who issue published reports or are listed on the New York or other stock exchanges; a description of the management advisory services department (see Chapters 1 and 2), the tax department, and any other similar pertinent material.

Competitive Bidding

It is obviously unprofessional and self-defeating for professional men to attempt to secure, on a price basis, the accounting work either of a new enterprise or of a corporation that wishes to replace its present auditors. In many states such a practice is now forbidden by the code of ethics of the state society or the rules of the State Board of Accountancy.

These rules, though approved in principle by the great majority of the accounting profession, have not been tested in any court action and might be held to be in restraint of trade. Nevertheless such conduct even where not specifically pro-

hibited is generally considered to be opposed to the ethical bans on solicitation, of which practice competition based on price alone is in effect a variant.

The stress on cost rather than quality, which is the inevitable result of price competition where a service not measurable in any objective way is concerned, is the primary reason for the opposition to such practices. Another reason is that it gives a large, well-financed, and somewhat unscrupulous firm, if such there be, an advantage over the smaller firm which cannot afford to take substantial initial losses on work merely to "get a foot in the door."

If all the arguments against price competition are admitted, how may this be reconciled with the practice of submitting proposal letters to prospective clients?

"Proposals" Not Competitive

A properly prepared proposal letter is not competitive. The services offered should be described, not extolled, nor should they be compared with what other firms have to offer. Proposal letters should be submitted on invitation only, never gratuitously on the accountant's own initiative.

If the client is changing auditors the accountant submitting a proposal letter should inform the retiring auditor that he has done so. So long as a proposal does not involve an offer to do work at less than cost plus a reasonable profit, it can hardly be described as competitive. Furthermore, if a range of cost is indicated, with a possible variation of 20 to 25 per cent between the high and the low, the accountant is giving the management information on which to come to a decision rather than making a bid of any sort. Even when a range of cost is given, the accountant should, and usually does, qualify his estimate for possible additional work not contemplated in the original proposal.

One of the example letters below was for an educational organization so badly organized that no firm estimate of cost could be given because of the obviously inadequate records and control. Nevertheless, enough information was given for the directors to come to a decision on the audit.

Some sort of a proposal is necessary in arranging for new

work, and so long as this is factual and provides for a fair range of fees, properly qualified, it does not appear to go contrary to the spirit or the letter of the national and state ethical codes.

Such a proposal gives the prospective client essential information and provides the accountant with a sound basis on which to plan his operations. Within the limits outlined the proposal letter is essential to the successful operation of a progressive accounting practice.

Representative Proposal Letters

Mr. William Stagg
Vice President and Controller
and
Mr. John A. Doe
Auditor
Universal Trust Company
New York, New York

Dear Sirs:

We are pleased to have had an opportunity to discuss with you our possible engagement as independent accountants to examine the 19x8 financial statements of Universal Trust Company. As requested, we have outlined below for you and for presentation to your management the general concept of such an examination, examples of audit tests involved, the staff to be assigned, the timing of the work, and our estimate of its cost.

General concept of the examination

Our examination of the consolidated financial statements of Universal Trust Company and its subsidiaries will be made in accordance with generally accepted auditing standards and accordingly will include such tests of the accounting records and

such other auditing procedures as we consider necessary in the circumstances. The scope of our examination will be sufficient to enable us to report to the board of directors and shareholders that, in our opinion, the consolidated financial statements present fairly the financial position of Universal Trust Company at December 31, 19x8, and the results of its operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

In addition we shall be prepared to sign, as independent public accountants, the certification required to be included in the annual report to be filed under Regulation F of the Board of Governors of the Federal Reserve System. Also we shall be in a position to report annually to the Directors' Examining and Audit Committee on our review of the auditing and credit audit departments. We shall also furnish comments and suggestions on operating and audit procedures developed in the course of our work.

In our examination, we shall give important weight to the system of internal control and the internal auditing program that we know are in effect at Universal Trust. Our examination will encompass three broad areas of activity as follows:

1. Review of operating procedures, internal controls, and auditing department organization and procedures:

   Detailed review of the procedures followed by the various operating units of the bank to evaluate the extent to which a sound system of internal control continues to be in effect, together with a review of the continuing adequacy of the auditing department's programs and procedures viewed in the light of the strengths and weaknesses of the system of internal control. Generally, this intensive review will emphasize certain departments each year with a view toward complete coverage over a cycle of several years, and at the same time it will be adapted to significant changes in procedures of particular operating units.

   General review each year of key internal control features, developed from our working papers on previous detailed reviews, in all operating units not scheduled for detailed review.

Continuing consultation with bank personnel on all significant changes contemplated in operating procedures, accounting principles and practices, auditing department procedures, organizational structure, or any other matters of interest or concern to us.

2. Participation in and observation of examinations conducted by the auditing department:

   Active participation with the auditing department in their examinations of certain operating units. These participations will be made with respect to some operating units every year and others every two or three years, depending upon the importance of the units in terms of our responsibilities in the examination of the bank's financial statements.

   Observation each year of auditing department examinations of operating units not scheduled for active participation. In the course of this observation, particular attention will be paid to adequacy of scope, satisfactory disposition of differences developed, and conclusions reached by the auditing department based on the examination. It will include a review not only of the work in progress but also of the working papers and reports prepared on the examination.

3. Independent tests of transactions:

   Independent tests of the activities of the various operating units of the bank such as those illustrated below, to supplement all the foregoing so as to conclude whether, in our opinion, the financial statements of Universal Trust Company present fairly its financial position and result of operations in conformity with generally accepted accounting principles consistently applied.

Examples of audit tests involved

Tests of the bond department's year-end market valuation of the investment portfolio and trading account securities and review for any securities against which a reserve provision should be made. Test counts and confirmation of securities to supplement to the extent we deem appropriate the work of the auditing department.

Examination of documentation on selected loans, including

inspection of collateral, and confirmation of loan balances and collateral with customers as a supplement to the examination by the auditing department. This will be done on randomly selected accounts at a surprise date during the year and on selected significant loans in the loan portfolio at year end, utilizing available records to the extent practicable and minimizing disruption of regular routines.

Review and test of the activities of the credit audit division, independent review of selected loans, and review of adequacy of the reserve for possible loan losses.

Tests of significant activities at a few selected branch offices each year.

Tests of corporate agency and corporate and personal trust department activities, including physical inspection of selected assets, tests of transactions, tests of collection of income, inquiry into frequency of investment review, and other tests.

Review of adequacy of amounts provided for taxes on the bank's income. This review will be made jointly by our audit staff and a specialist from our tax department. Also our tax department will review generally, but unless specifically engaged for the purpose not in detail, the bank's income tax returns.

Tests of bank income and expenses, including review of controls (i.e., budget variation reports), interest accounts, payrolls, and other income and expense accounts.

Tests of other general ledger accounts, with particular attention to prepaid expense, deferred income, accounts payable, and accrued liability accounts.

Tests of "off balance sheet" accounts such as assets pledged and commitments.

Staff to be assigned

Mr. Nicholas Nickleby, partner, will be responsible for the over-all coordination and successful completion of the examination. Mr. David Copperfield, manager, will be responsible for direct supervision and coordination of the staff.

In addition to Mr. Nickleby and Mr. Copperfield, we shall assign to this engagement approximately three senior staff members who will be responsible for the conduct of the work. They will be assisted from time to time by additional staff

members as required.

As in any of our audit engagements, there will be available to the audit staff and to your bank the services and facilities of our tax, research, and management advisory services departments. Our management advisory services department can provide expert assistance in such diversified areas as electronic data processing, accounting systems, operations research, cost accounting, general cost reduction, improvement of management reports, budgets and forecasts, and many others.

Timing of the work

Cognizant of your desire to publish 19x8 financial data as soon after the year end as possible, we shall carry out as much of our work as practicable during the course of the year. We estimate that we shall be able to perform approximately 80% of the work prior to year end. We expect that we shall be in a position to render our opinion before the end of January.

Cost of the work

As you are aware, the fee for our services will be based on hourly rates for the time expended by our staff. You will appreciate that not all the complexities or situations that may be encountered in an examination of this type can be foreseen, and therefore the accuracy of any fee estimate is limited. Nevertheless, we estimate that our time charges for an annual examination will be between $70,000 and $80,000. We would also expect to be reimbursed for out-of-pocket expenses which will be minimal. We would propose to render bills on account as the work progresses.

* * * * *

We look forward to this opportunity to be of service to Universal Trust Company. If there is any other information we can supply you, please let us know.

Yours very truly,

____

Mr. Arthur Jones
Executive Director
Vocational Training Centers, Inc.
Cleveland, Ohio

Dear Mr. Jones:

In order to comply with your request that we undertake an examination of the financial statements of Vocational Training Centers, Inc., for the year ended December 31, 19x8, members of our staff spent two days in your offices to determine the problems involved in performing such work.

Based upon this brief survey, which included discussions with various employees and evaluation of accounting records, we have concluded that an audit is feasible. However, the following weaknesses in record-keeping and internal control were noted by our representatives and cause us to believe that the work will be unusually time-consuming because of the need to extend our tests to limits not normally comprehended when records and internal controls are in order:

1. Bank accounts have not been reconciled during the year. Approximately 20,000 disbursements have been made during this period.
2. Documents supporting purchases of goods and services frequently lack indications of approval, receipt, account classification or purpose.
3. Filing in the accounting department is not current, and some items are misfiled.
4. Significant sums have been disbursed through petty cash, and supporting documents for some of the disbursements are lacking or incomplete.
5. Records showing hours worked by various staff and youth workers may not be readily available for certain periods.
6. Shop and office equipment records are incomplete at this time.

It is possible that during the examination problems will be disclosed that we did not observe during our initial visit. We note that efforts are presently being made by your personnel to improve procedures and controls concerning both the shop

work training and the financial activities of the organization.

In view of the problems mentioned above, I am sure that you can appreciate the difficulties we shall encounter in performing an examination and that these difficulties would necessarily give rise to more extensive tests of the underlying records supporting transactions in an effort to report as positively as possible. Even so, you must understand that the lack of proper documents and the existence of inadequate procedures and controls during the period under examination would in all probability require comment upon or a qualification in our report, and it may be that we will not be able to provide an opinion on the financial statements. Finally, you should also understand that we might not be in a position to determine that the expenditures were justified or reasonable in terms of program.

As I explained to you during our earlier meeting, fees for our services are based on hourly rates for the time expended. Because of the various matters mentioned in this letter, it is not practicable to estimate a total fee to complete this examination, but it now appears reasonable to assume that it might aggregate $10,000 and could be much more if completion of the bank reconciliations referred to above were to disclose numerous unexplained differences. Accordingly, I suggest that we await completion of that phase of the work by your staff before discussing further the economics of undertaking the assignment as a whole. In the meantime, I should be glad to make available the services of one of our staff to advise your people to the extent necessary in the completion of this very necessary task.

Yours very truly,

APPENDIX

A

Responses of C.P.A.'s Concerning Practices and Services

The sample represented by this questionnaire covers a large proportion of the professional accounting work done in this country. Ten international and national firms responded. These firms have offices throughout the country and thus represent conditions in all states and in all industries.

Thirty-five regional and local firms replied. They range in size from one small office to regional firms with several offices covering several states. All parts of the country and many different types of practice are represented.

The questions were designed to cover the more important and difficult problems of the practical operation of an accounting practice rather than questions of accounting principle or auditing methods.

For obvious reasons it would be improper and unfair to identify the firms answering the questions, and where answers have been quoted these have been edited, where necessary, to make identification impossible.

Question 1

Are your clients fully aware of the various types of service you are prepared to render?

International and National Firms. All but one of the international and national firms replied in the negative.

Representative Answers. I would answer this question "yes, they are," but it is important in a practice to make these services constantly known to clients at the time the clients are in need of them. This takes a great deal of contact with clients and discussion of the various problems facing them. Many times the accountant is not aware of the problems facing the client because he is so preoccupied with checking on the bookkeeping.

The problem we face in making clients aware of the various services we are prepared to render is one surely that is faced by the entire profession. Our clients are generally aware of our services, but there is a continuing need to bring specific areas to their attention. They are receptive to our efforts to do so; the initiative generally rests with us.

Regional Firms. Affirmative, 17; negative, 15; 3 answered that some clients were aware of types of services rendered and some were not.

Representative Answers. We believe that our clients, generally, have very little knowledge of the types of services we are prepared to render, except accounting, auditing, and income tax return preparation.

Generally speaking, yes, because we are very close to our clients, virtually on a day-to-day basis. However, in two instances through the many years, a client heeded the siren call of one of the widely advertised national "engineering and systems" organizations, at high cost and vast disillusionment (throwing the system out after paying more than ten times the cost of our annual service).

Not fully. From various sources, and with frequency, clients are deluged with advertising and other literature through the mails suggesting means of acquiring "know hows". Often, these evoke interest and initial inquiry from clients to the accountant. The services, particularly in province of accountants, are offered by others (bankers, insurance counsellors,

etc.) as an opening wedge to securing patronage for the major services of their institutions.

Generally speaking—Yes, except as to management services, electronic data processing, clerical work measurements, and estate planning.

Question 2

If not (in answer to Question 1), are you taking any steps to remedy this condition?

INTERNATIONAL AND NATIONAL FIRMS. All answered in the affirmative except one.

Representative Answer. We have prepared a brochure setting forth the various types of services that we are equipped to perform which we make available to a client or prospective client when appropriate. Also, we have a house organ that is distributed to our staff and clients.

REGIONAL FIRMS. Affirmative, 20; negative, 11; 4 did not answer.

Representative Answers. Partners and staff are alerted to introduce, in course of personal contacts, as situations develop or need is indicated, the advisability of a survey and recommendations. Because of previous exposures, as indicated in Question 1, this is not the first time the client has heard of these services. However, the capacity of accountants to fill the requirements, surprisingly, is viewed as reaching out or usurping a field of activity that is believed to be for others, whose qualifications are touted as superior. There is a reluctance by us to enter an arena. We increase the promotion of new and useful avenues of service to the client as interest and encouragement is evidenced even to a slight degree.

Yes. We are building up our staff, which now consists of seven C.P.A.'s and six non-C.P.A.'s, as we find qualified personnel interested in our area. As we are better staffed to handle the work we will be able to extend more types of service to our present clients.

Yes. These steps include continuing discussions with responsible executives, directed to a consideration of the problems (not related to financial statements or taxes) soluble by means of services not within the "normal" ambit of accountants. (For example, a determination and evaluation of labor productivity as related to pricing formulae.)

Question 3

If you are not able to render all services required by your clients, for example, operations research, electronic data processing, or foreign representation, do you have some regular arrangement with a firm equipped to render these services or do you make your arrangements as the occasion demands?

International and National Firms. All stated that they could render these services or had satisfactory arrangements to supply anything lacking.

Representative Answers. We are able to supply all the services that our clients need in all of these areas. If we are not in a position to perform the service that a client needs, we would make it clear that more competence is available elsewhere and we would try to help secure that competence.

Our firm is able to render all services encompassed in certified public accountancy. Certain other services (such as psychological testing, professional engineering, or actuarial consultation) are arranged for, generally by referral, as occasions demand.

We have affiliates for the client needs in foreign countries. For other services where we lack capabilities, we make arrangements as the occasion demands.

Regional Firms. Thirty-two made arrangements as the occasion required; five had regular arrangements; two had none.

Representative Answers. Arrangements are made as occasion requires. This is not as it should be. A prerequisite is some indoctrination in what the specialists do that can benefit a client. It would be a progressive step for a partner or high staff member to probe into the utilization of services of spe-

cialties to fill certain requirements of clients, under guidance and control of the accountant.

While we are equipped to render a wide range of services such as operations research and electronic data processing, in the area of foreign representations we have in the past established relationships with foreign firms as the occasion arose. In a number of instances we have had occasion to again require foreign representation in those countries and have used the same firm.

Question 4

Do you specialize in one or more industries? If so, what are they?

International and National Firms. All but one answered in the negative.

Representative Answer. No, we do not specialize in particular industries, but have many clients, large and small in most industries. Although our clients comprise the major portions of certain industries, none of these industries is a predominant part of our practice. We believe that broad professional capability has greater importance than complete familiarization with the characteristics of certain industries, although we strive to achieve that also.

Regional Firms. All but six answered in the negative.

Representative Answers. Do not specialize intentionally but, due to recommendations of clients, have higher place in electronic field than others.

We do not intentionally specialize. However, a substantial part of our work relates to food processors, since we are in an agricultural area that produces up to three crops of food stuff each year.

We have partners who are to some extent specialists in particular industries such as newspapers, finance companies, governmental subdivisions, etc., and they consult with other partners or offices when needed.

Question 5

Do you specialize in one or more types of practice, for example, cost accounting, government contracts, state and local taxation, or regulated utilities?

International and National Firms. All negative.

Regional Firms. All but two negative.

Question 6

A frequent organizational grouping is:

a. Audit and investigation, including reporting
b. Taxation
c. Statements for the Securities and Exchange Commission
d. Management advisory services
e. Estates and trusts, including accounts of individuals.

To what extent is your firm organized departmentally?

International and National Firms. All organized departmentally.

Representative Answers. Operating control of our practice is decentralized with practice offices providing comprehensive professional accounting services under the direction of local partners-in-charge. Functional control of the areas of (1) accounting and auditing (technical procedures and standards, SEC, industry specialists, basic and applied research), (2) tax, (3) management services, and (4) international practice is centralized in our executive office. Administrative functions (e.g., personnel and training, firm publications, etc.) also are departmentalized in the executive office.

There is a certain degree of functional organization and separation within our organizational structure. Generally speaking, the categories we would use are:

1. Accounting, Auditing, and SEC Services
2. Management Consulting Services
3. Tax Services
4. Actuarial and Employee Benefit Plan Consulting Services
5. International Services

REGIONAL FIRMS. Fourteen organized departmentally; 24 not.

Representative Answer. Because of the small size of our firm, a detailed organizational grouping such as you have set forth in your question is not possible. However, one of the partners specializes in taxation, estate planning, and corporation organizations and reorganizations. Another specializes in systems and procedures and management advisory services. Another specializes in audits. However, the lines are frequently crossed especially at the review and consultation level.

Question 7

Does your departmental grouping differ from that outlined? If so, how?

INTERNATIONAL AND NATIONAL FIRMS. No important difference from organization outlined in Question 6.

REGIONAL FIRMS. No important difference from organization outlined in Question 6 where firms were organized.

Question 8

Do you have a description of audit services beyond the usual type for staff use or for information of clients? If you have such a list, is a copy available?

INTERNATIONAL AND NATIONAL FIRMS. All negative.

REGIONAL FIRMS. All negative but one.

Representative Answers. For the most part our audit work follows the standard pattern. We have, however, developed a special service for small commercial banks which supplements their own internal control program, and which is designed as an aid to bank management rather than to develop certified statements. An outline of this program as applied to one bank is enclosed.

We do not have such a description, but we have long recognized that it is necessary, and it will be prepared soon.

Question 9

Besides the usual preparation of state and federal returns, and representation of clients in controversies with the Internal Revenue Service and state tax authorities, do you assist your clients in:

a. Estimating the tax effects of proposed transactions,
b. Advising on the tax effects of different methods of organizing a new venture,
c. Advising on the timing and treatment of security transactions,
d. Advising on the effect of proposed tax legislation, domestic or foreign, or
e. Advising on the organization of a client's own tax department?

International and National Firms. All affirmative.

Regional Firms. Eighteen provided all services; 15 did not advise an organization of client's own tax department; 3 did not advise on the effect of tax legislation; 1 did not advise on the timing and treatment of security transactions.

Question 10

If you have a separate department dealing with SEC affairs, is this combined with a department or group devoted to research work?

International and National Firms. All but one stated that, while a department dealing with SEC affairs was not combined with the research department, the two departments were closely coordinated.

Regional Firms. Only one had a department for SEC work; 22 had no department; 12 had no SEC work.

Question 11

If your practice includes a substantial number of regulated utilities, do you have a separate department for this type of client or do you serve these clients through your general audit staff?

International and National Firms. Three firms had a separate department.

Representative Answer. Yes, a separate department in our executive office works with and advises practice office partners in utility accounting matters.

Regional Firms. Thirteen had no department; 23 had no practice in regulated utilities.

Representative Answer. Our practice does include a number of regulated utilities, and these are serviced by members of our general audit staff, who are thoroughly competent in this area.

Question 12

The following is a condensed and partial list of services that might be expected from the management advisory service department of a highly organized accounting firm:

General management
- Business planning, statements of objectives and policies
- Organization structures and responsibilities
- Integrated management information and reporting systems
- Major cost reduction and profit improvement programs

Financial
- Accounting systems
- Budgets and long-range plans
- Manufacturing cost systems
- Distribution cost systems
- Capital expenditure evaluations
- Return on investment and other performance measures

Manufacturing
- Production scheduling and inventory control
- Maintenance control
- Quality control
- Factory work simplification and work measurement
- Material and labor standards
- Warehousing methods
- Layouts of warehouses and simpler plants

Marketing distribution
- Marketing organization and administration

Salesmen's compensation
Product line evaluation programs
Profitability of products, territories, distribution channels, etc.
Marketing research

Personnel

Wage, salary and executive compensation
Incentive plans
Merit rating and job evaluation

Administrative support

Office, plant, and other departmental procedures
Electronic data processing and other forms of mechanization
Communications
Records management and data retrieval
Office layout
Clerical work simplification, work measurement, work standards

Is your firm prepared to render any service beyond those listed?

International and National Firms. All but one stated that they did perform services in addition to those listed.

Representative Answers. Generally, we furnish services in most of the areas referred to here and many others which come up on individual jobs. We do not attempt to work on such matters as layout of warehouses and plants, determination of salesmen's compensation, market research, merit rating or job evaluation. Matters that do not relate to the collection of data and the presentation of data are not a responsibility we can assume. In the area of market research we may lend assistance in obtaining and developing facts with respect to the past; however, to develop a market plan for the future is not a responsibility we would undertake, nor do we believe that any accounting firm should undertake to provide that kind of service. In general we recommend management engineers in this field, and work closely with management engineers to the extent we can be of assistance.

Yes; we render many but not all of the services listed. Beyond these, we have been called upon to consult in other areas such as pricing problems and Robinson-Patman matters, mathematical and operations research techniques, and sales forecasting.

No, except actuarial services.

In addition to services outlined we make feasibility reports in regard to proposed new hotels and motels.

Regional Firms. Five were prepared to render additional services; 29 were not.

Representative Answers. Yours is an excellent list of services; some of the skills listed are beyond our fields. However, as to "any service beyond those listed," I gently offer this: I am, as you know, a lawyer and a C.P.A.; despite the American Bar Association's seeming disapproval of the joint practice (and the efforts to move the A.I.C.P.A. to a like end), I may say, immodestly but emphatically, that many clients find that the joint skills, united, often yield better results at less cost.

Yes, economic and market studies for proposed projects in our specialized field (hotel and club accounting).

The only additional item that occurs to me is assistance with obtaining qualified high-level personnel in the financial end.

An important service rendered by our firm that is in part a function of the management advisory service department and in part the function of a managing partner is to aid in negotiations for the purchase and sale of businesses, the arrangement of banking lines, the development of financial programs and assisting in many policy making decisions.

Evaluation of advertising and public relations programs. Direct representation at banking and financial institutions. Direct representation in same areas of collective bargaining.

Question 13

Do you render any special services for particular industries, for example: textiles; petroleum; ranching or agriculture; retail trade; special types of manufacturing; hotels, clubs, and motels; or furniture?

International and National Firms. Three replied in the affirmative.

Representative Answer. If the question is to be interpreted as asking whether we serve particular industries to the exclu-

sion of virtually all other firms, and in doing so perform services beyond the normal scope of auditing, management advisory, and tax services (e.g., to serve additionally as the medium for gathering and disseminating industry statistics), our answer would be "No." We do provide special services in certain areas such as in public utilities and transportation.

Considerable special services for hotels, clubs and motels. We have specialists knowledgeable in actual operations. We compile statistical data in regard to the respective industries.

Yes. We prepare statistics for certain trade organizations.

Regional Firms. Affirmative, 13; negative, 24.

Representative Answers. Special services for supermarkets and oilwell drilling contractors.

We render special services to the organized wine industry.

For some years we have had a department specializing in record keeping machinery and we have one man who studies the revolution in accounting machinery that has been and is going on. As a result of this we have made several installations in the wholesale jobbing trade and consider ourselves experts in this field.

Yes. Hotels, clubs, hospitals, etc. (motels, motor hotels).

Processing fruits for canning and packing—tanning reptile skins.

We are experts in the music publishing field, which is very specialized.

In textiles, inventory controls. In retail chain stores, inventory controls.

Question 14

Where no opinion can be given after a partial examination of financial statements, what of the following procedures are most usually omitted? Please mark them in order of frequency, most frequent being marked "1":

a. Physical tests of inventories
b. Confirmation of accounts receivable by direct communication with debtors
c. Count or independent confirmation of securities owned or

held for safekeeping or in the client's possession for other reasons

d. Direct confirmation of cash balances by banks or other custodians

e. Generally, physical or independent verification of any material asset or liability

INTERNATIONAL AND NATIONAL FIRMS. There is more agreement than is shown by the regional firms but still great diversity except on items (a) and (b).

Frequency Index	a	b	c	d	e
1	5				1
2		6			1
3			3		1
4			1	2	1
5			1	2	2
	5	6	5	4	6

Representative Answers. I believe that most of the "no opinion" reports that we render relate to major uncertainties such as questions regarding realization of assets in a new company, pending litigation, etc. We have relatively few situations where some generally accepted auditing practice is omitted, giving rise to "no opinion" reports.

The situation envisioned in this question is largely inapplicable in our practice although we do have some instances where no-opinion reports are submitted and these would substantially be because of the failure to follow the extensions of audit procedure.

REGIONAL FIRMS. Not all firms answered. There is little agreement except on items (a) and (b).

Frequency Index	a	b	c	d	e
1	20	7			
2	7	16			2
3		1	9		8
4		1	7	3	6
5			1	12	4
	27	25	17	15	20

Representative Answers. We don't make "partial examinations."

We rarely issue no-opinion reports. When we do, it is usually for a special purpose where client has other means of satisfying himself regarding omitted procedure.

1. Omit (a) Physical tests of inventories; 2. Omit (b) Direct confirmation of receivables. We would rarely, if ever, omit (c), (d), or (e). On the other hand, we favor more frequent and regular confirmation of payables (strangely not stressed by A.I.C.P.A.).

The procedure most frequently omitted to preclude an expression of opinion is adequate physical testing of inventories. This is particularly true on new engagements where there is no proper certification as to the opening inventories. Non-opinion reports are declining in economic importance in our practice. The only other practical reason for no-opinion reports exists in cases where the client does not want an opinion and will not have one expressed under any circumstances.

Generally, the only partial examinations of financial statements where no opinion can be given are in the case of interim work. In these instances the most usually omitted procedures are (a) physical tests of inventories and (b) confirmation of accounts receivable by direct communication with debtors.

Question 15

Do any of your clients rotate auditors from year to year?

International and National Firms. All negative.

Representative Answer. We know of no clients who rotate auditors on a year-to-year basis or on any regular basis for that matter. Often the "rotation" excuse is used to justify a change for another reason. We are practical and recognize the reasons for what they are.

Regional Firms. All negative except three.

Representative Answers. None of the ordinary clients, but a city administration selects various accounting firms at various times for the departments that are audited by C.P.A.'s.

One client rotates auditors every five years. None rotate every year.

The rotation of auditors in our practice is not a significant factor. There are a few governmental and eleemosynary institutions that rotate on a three or five year basis.

Question 16

What do you think of the advantages or disadvantages of this practice?

INTERNATIONAL AND NATIONAL FIRMS. All opposed.

Representative Answers. Our firm is sufficiently large that most of the benefits of rotation are secured by:

a. Continuous rotation of field staff on planned basis.
b. Turn-over of personnel including managers.
c. Growth and introduction or reassignment of partners.

The cost of rotations to clients, we believe, exceeds the benefits obtained, except in the presence of special circumstances such as major shifts or turnover of management, poor performance, etc.

Value of continuity. Efficiency in performing annual audit due to familiarity with company's background, problems, and practices.

Consistency in auditing and reporting practices.

Costly and time-consuming to introduce a new firm.

Fresh viewpoints obtained by periodic rotation of personnel of accountants.

Unfavorable reaction of business community to rotation—might cause financial community to wonder why change was made—was it that company adopted accounting practice that was unacceptable to auditors of long standing.

REGIONAL FIRMS. All opposed, but one, which recommends that rotation be limited to publicly held companies.

Representative Answers. From point of view of clients, annual rotation of auditors appears to offer fewer advantages than disadvantages. First audits tend to be expensive, and if the

expense is not now borne by client when occasional change of auditors occurs, it would be if rotation were adopted. Lack of familiarity with a situation may overburden auditors to the degree that possibility is lost of breaking new ground, making constructive recommendations. These disadvantages more than offset the advantages of a new point of view (not fruitful every year) and added alertness which a new auditor may exhibit. From point of view of auditors the situation is similar: auditors would be required to spend more time in "learning" a job, leaving less time and thought for constructive efforts beyond the call of duty.

While a claimed advantage might be the fresh approach of another mind, our limited experience with rotation suggests that the disadvantages prevail: Unwillingness of both client and auditor to undertake changes that may be of limited duration; confusion and uncertainty; very likely added costs; the loss of continuity of experience, thought, and consecrated dedication enjoyed by "permanent" clientele.

From the client's point of view, the same effect can be gained from alternating staff and partners in the same firm.

Question 17

Do you generally get adequate cooperation from your clients?

International and National Firms. All affirmative.

Regional Firms. All affirmative but one, which says they do not get adequate cooperation from small clients.

Representative Answers. Yes, except when an accounting department suffers from turnover of personnel (for whatever reason), and from problems beyond its ability or capacity—following a merger, or associated with rapid growth, etc.

We usually get splendid cooperation from our clients. The exception would be the unusual case where we represent some adverse interest.

Too many of our clients' clerical staffs do not have the time or talent to prepare trial balances, analyses, and schedules for our use which would reduce our total hours.

Question 18

If not (in answer to Question 17), what, in your opinion, is generally lacking?

International and National Firms. (Position is summed up in the following answers.)

Representative Answers. Whenever a situation of inadequate cooperation exists, it may be brought about by the fact that the client's personnel are overloaded (sometimes because of inadequate personnel), and we must make up for such shortcomings. Although our policy is to serve reputable concerns only, occasionally a client may attempt to pursue an ill-considered or evasive course of action. It is then our professional responsibility to try to persuade him to follow a proper course, one that will stand test of sound performance in the long run; and sometimes we are obliged to withdraw from an engagement when a meeting of minds cannot be obtained. Generally, the outcome is a rational course of action acceptable to all concerned.

Where cooperation is not completely satisfactory, it is generally due to inadequacies of client's staff.

Regional Firms. No answer, 21; 2 said lack of cooperation is generally the accountant's fault; 12 said it was generally the client's fault.

Representative Answers. 1. Client is in some difficulty and audit is being forced on him. 2. Insecurity on part of one or more employees of client. 3. Employee of client has worked for or has connections with another C.P.A. firm.

In the rare instances when cooperation is lacking, we find:

1. There is occasion for us to suspect irregularity by the client; unless cleared up, we withdraw.
2. Or, the client does not recognize that cooperation on his part and on the part of his own staff will tend to reduce audit costs; education by us ordinarily removes this difficulty.

We generally get adequate cooperation from our clients. Occasionally our clients enter into transactions without first

seeking our advice. We discourage this whenever we can to avoid possible serious tax and other financial consequences to the client.

The lack of client's cooperation is due almost entirely to the accountant's inability to communicate, or to his own lack of interest.

Question 19

Are your clients willing to keep you currently informed about their affairs in general?

INTERNATIONAL AND NATIONAL FIRMS. All affirmative.

REGIONAL FIRMS. Affirmative, 24; affirmative with qualifications, 10.

Representative Answers. Most of our clients are *willing* to keep us informed about their affairs but many do not seem to understand the importance of furnishing us with information about their operations except at the close of the year. Some are unaware of the necessity or desirability of consulting with the auditor or tax consultant.

Personal tax clients generally do not realize how important it is to keep us currently informed of their affairs. Frequently they fail to tell us of substantial capital gains not anticipated in estimates. When the ultimate additional tax is substantial, the client registers great surprise. Stupid! *N'est-çe pas?*

Yes, definitely; most of them rarely take any new step without first consulting us.

Yes. They are with our partners, but will often refuse to pass some information on to our staff members.

Yes—but again, this requires continuing efforts on the accountant's part in the demonstration of his own active interest. No one who performs merely a cut-and-dried annual audit can long expect a "consulting" client.

Our current contacts with clients are limited largely to situations where advice on tax questions is needed. In our opinion we are deficient in not keeping in closer contact with our clients.

Question 20

Do your clients cooperate in arrangements for doing interim work?

International and National Firms. All affirmative, although one says there are some exceptions.

Regional Firms. Affirmative, 31; affirmative with qualifications, 2; negative, 1.

Representative Answers. Most of our clients cooperate in arrangements for doing interim work. A few have thought that interim work increases the cost and have objected to it.

Not particularly. There is still a feeling that too frequent exposure to auditors is an intrusion or interference with the orderly, daily routine program of office operation.

Yes. However, through extensive use of the natural business year, we have a very even flow of work on a year around basis, and therefore do interim work only when it is of special use to the client.

Yes. Interim work is usually acceptable to our clients, and is automatic in many instances. The time for doing the work is arranged in cooperation with the client's office, except in cases involving surprise counts or examinations.

Question 21

What are your views on ethical public relations:

a. For the C.P.A. firm or practitioner?

b. For professional organizations?

International and National Firms. All of the firms believe that something should be done to improve the public relations of the individual firm and of the profession as a whole, but there is a wide diversity of opinion on just how this should be done.

Representative Answers. Ethical public relations for the firm implies advancing and supporting the profession as a whole

with the result that its members share the profession's stature. Ethical behavior implies living up to the spirit as well as the letter of the A.I.C.P.A. code of professional ethics. Paradoxically, ethical restraints in our view are a public relations strength, and not a limitation on professional behavior. For professional organizations, public relations efforts should be directed toward motivating individual members toward excellence in every respect; the function is advisory, and publicity is a working tool to be used with great care and precision. The American Institute and State Societies should show their members how to reveal acquired excellence tastefully and convincingly to the end that clients, bankers, lawyers, and other special publics will understand the capabilities of certified public accountants.

We are not sure that we understand this question. As a firm we endorse the A.I.C.P.A. Code of Ethics and favor a rigid interpretation. In some instances we believe that professional courtesies require a standard higher than that set in the Institute's Code and in such instances we try to govern our conduct accordingly.

I do not clearly distinguish between (a) and (b) since in many areas the two overlap. In general the professional organization can and should be charged with the duty of widespread dissemination of information as to the capabilities and limitations of the profession. The practitioner, except as he speaks in furtherance of (b) should in general not touch his particular capabilities as opposed to those of the profession but rest his own capabilities on the public's evaluation of his past achievements.

To maintain the dignity of a profession, ethical public relations are essential. Among the requirements therefor are the avoidance of even the appearance of soliciting clients, and especially clients of other C.P.A.'s, and adherence to high standards of work with integrity and independence in reporting thereon.

Regional Firms. The regional firms are in substantial agreement with the larger firms, except that they seem to have more reservations and misgivings than the international and national firms, as the representative answers indicate.

Representative Answers. (a) If the C.P.A. firm or practitioner adheres *strictly* to the rules of professional conduct of the Institute there is little or no opportunity to conduct a public relations program or a client relations program. Our firm, and particularly myself, has been exceptionally active in civic affairs, community affairs, maintains membership in various organizations, including the Country Club. But this does not get the message over to our many clients as to what we can do for them—and, in many cases what they *need* to have done. I could discuss this at great length. (b) Public relations programs carried on by the Institute are of necessity quite broad. They are designed for the profession in general. And, I dare say, most of the information disseminated by the Institute does not get to the average client. State Society programs, if the State Society has such, are more direct and deal with problems and conditions of the particular area. However, our State Society public relations program is practically non-existent. To get the maximum results, and to get the message to the clients, yes, to educate the clients with respect to what the accountant has to offer the client, a *direct* public relations (or client relations) program is necessary.

I am in full accord with general policies and trends in ethics promoted by A.I.C.P.A. The individual C.P.A. must build his reputation by his own personality, the firm by its service to clients and the profession as a whole by the public service of the professional organizations.

(a) We have a program of having our partners join service clubs and other organizations with a view to meeting people. Our partners also frequently speak before service clubs and other organizations. Our accent is on meeting as many persons as possible without actively soliciting. As far as our own clients are concerned, and we consider them an important part of our public relations efforts, we try to do the best work that we can and present a good picture to them as far as our reports and communications are concerned. Also, periodically we issue bulletins to our clients covering changes in the tax laws. These have proved very effective in making them conscious of our existence. We also are actively expanding our management services program in connection with our client relationship ac-

tivities. You have asked for a suggestion of new areas that your questionnaire might develop. Perhaps you should divide your public relations for the C.P.A. firm or practitioner with his own clients and/or with persons who are not his clients. Also under (b) what kind of professional organizations do you mean? Our partners are frequently asked to speak before professional organizations of various industries. Do you mean this type of professional organization or do you mean the organizations of the accounting profession? If it is the former we believe that when we are invited to speak or attend meetings of professional organizations we may do so and present the best picture of our firm as possible without soliciting. If it is the latter, we believe that our accounting professional organizations are a fine medium to use to improve the public's picture of our professions. All members of our firm and staff are encouraged to take part in the affairs of the organizations of our profession.

I am inclined to believe that BOTH the C.P.A. and the A.I.C.P.A. are too timid, too reserved, "too ethical," in their public relations. We should LET THE PUBLIC KNOW MORE—educate the public more—both in frequency and in depth. I think the proposed new rule on "solicitation" goes too far (far beyond the BAR rule). NOT THAT OUR FIRM HAS ANY INTEREST IN THE MATTER FOR OURSELVES: WE GET ALL THE BUSINESS WE CAN HANDLE, WITHOUT LOOKING FOR ANY, SIMPLY BY DOING GOOD JOBS.

Public relations, like the poor, are always with us—whether we want them or not, whether the "image" is good or bad. Since this *is* so, the engagement of counsel to assist both practitioner and professional organization seems entirely ethical and correct. Simultaneously, we must strive to improve the *substance* reflected by the "image."

Having served on the Institute ethics committee for several years and also on the Institute trial boards, I could discuss this question at some length.

(a) As a small firm, small town committee member I was a bit astonished to learn of the aggressive methods followed by one of the big eight particularly in the area of distributing technical material. A regional firm gave us some difficulty with

the question whether the senior partner was an author or an advertiser. On the whole I think the Institute has a very fair and comprehensive code of ethics, the enforcement of which could be improved by better organized cooperation with the state society committees. It seems to me that the situation is improving. The bane of our existence among the small firms is the lack of competence. It bewilders me that a person can pass the C.P.A. examination and yet apparently have no concept of the application of accounting principles and auditing standards in an actual engagement. Another damper on good professional posture is the frequency with which some local individual or small firm allows a strong-willed client to dictate what goes into a report. In Texas our faces were red when Bill Sol Estes presented a C.P.A.'s phony financial statement to the Department of Agriculture.

In your letter of March 31 you asked for opinions on what should and should not be done. Your own professional background plus what you have gleaned from conversations with other large firm partners doubtless leaves little that I could add concerning improper activities in that area.

In the case of the small fry the Institute and some of the larger state societies are doing a masterful job with the professional development courses for the benefit of those of us who are not exposed to large firm training programs. This should do much to improve our public image.

It is obviously a must for all of us to participate to the fullest possible extent in civic and social service activities. Through the years I have served in a host of activities all the way from secretary of the local Little Theatre to the office of mayor. My partner is now devoting about 20 per cent of his time to similar projects.

It has been argued that full fees should be charged for auditing charitable organizations, and then more substantial donations be made in return. This is a good theory but it isn't the practice here.

More than a few accountants, I have observed, seem to be reluctant to engage in any civic activity that will result in their names' appearing in public print. This attitude impresses me as a cover up for timidity or laziness rather than as a respect for the ethical code.

My reaction to your question concerning accountants as authors is that we do too little writing. If we have something to say about a public issue we should write a letter to the editor.

(b) It never occurred to me to question whether or not our national and state organizations were conducting their affairs in an ethical manner. I do feel strongly that the Institute and, to a lesser extent, our State Society, are both rendering tremendous services in improving the image of the profession as a whole.

Question 22

What are your views on the relations of the internal and the external auditor?

International and National Firms. All agree on the necessity of close cooperation between the internal auditors and the outside accountants, and all agree on the importance of independence on the part of the internal auditors.

Representative Answers. Every effort should be made to enhance the quality of services performed by internal auditors and to encourage their having the greatest degree of independence possible. Maximum cooperation between internal and external auditors is in the client's interest to provide a full range of accounting services at minimum cost.

If properly organized independently of operations, the internal auditor can properly carry out much detail work including preparation of schedules, reconciliations, etc. Where rotation is used as to divisions, etc., the outside auditor can properly omit any direct work if his review of the internal auditors' papers discloses no points requiring further investigation.

Where the client has an internal audit department, utilization can be made of internal audit reports, and the audit program modified. However, too often, internal audits are not of sufficient scope to be of much use.

The independent auditor should have the right of review of all internal audit programs, the right of inspection of work papers to see that the provisions of the program are being main-

tained at proper frequencies and to have available for inspection all reports submitted by the internal auditors. The audit program of the external auditor must necessarily then be patterned and substantially influenced by the program and results of the internal auditor's program.

Question 23

What are your views on the place of the C.P.A. as an expert witness? Descriptions of actual experience would be particularly welcome.

INTERNATIONAL AND NATIONAL FIRMS. All believe the accountant has an important place as an expert witness.

Representative Answers. The C.P.A. must be a capable witness if he is to perform the services expected of him by the public. He must establish himself as an independent person who checks the facts without bias, recognizing the public interest which is involved. The profession's training of individuals in the field of accounting is so poor that the average accountant does not make a good witness. Unfortunately, at the present time, the C.P.A. is often regarded as just another employee in a great many cases where he is asked to testify.

1. In testifying as to facts and events, his training usually results in a more precise presentation thereof.

2. In testifying as to matters of auditing and accounting standards and principles, he surely qualifies as an expert; the utility of his testimony depends on (1) his personal qualities as a witness, although usually he is more exact and less easily confused than many witnesses, and (2) the relevance of the particular testimony to the issues involved—frequently and unfortunately he may be used as a "strong witness" on the stand although his testimony (as an expert) may be remotely relevant to the issues.

3. On matters other than (1) and (2) his "place" depends more on his special qualities and background than on any general accounting or auditing training.

The individual C.P.A. can be a good expert witness within the scope of his particular experience and knowledge. As an

example, our firm performs many engagements for independent insurance adjusters employed by insurance companies. One of our partners who has had many years' experience in this field has successfully testified as an expert for insurance companies.

Regional Firms. All that have had any experience as witnesses believe the accountant is capable of acting as an expert witness, but there are several interesting replies that indicate the difficulties the smaller firm experiences with lawyers and courts.

Representative Answers. As an expert witness a C.P.A. fills a useful and necessary role. Sometimes it is difficult to be given the time prior to trial or prior to pre-trial hearings to educate the client's lawyer. In such cases the C.P.A. cannot contribute his best. In other cases the lawyers cooperate. In any event there is the difficulty of unraveling misconceptions that may be spun by the other side and of communicating with the court, including the jury when there is one. Perhaps the difficulties of C.P.A.'s as expert witnesses are no greater than those of other experts where explanations must be made to laymen.

In at least two occasions during the past three years the writer has been an expert witness on the stand where another C.P.A. has been on the opposite side and where conflicts developed. This was thought to be very unfortunate, as it must have developed a confusing picture of the auditing profession in the eyes of the outsiders present. A C.P.A. should approach any court case in which he is going to be an expert witness with a great deal of objectivity and try to avoid a position on a controversial matter where another C.P.A. might take the opposite side. He then becomes an advocate and loses his independence.

The C.P.A. has a definite place as an expert witness. Our experience is limited, principally because we avoid that kind of work. Many C.P.A.'s are of a retiring nature and shrink from the publicity and brow-beating associated with trials of any kind.

We do not like the title "expert witness." However, there is a very definite place for intelligent opinion testimony by a

qualified C.P.A. The C.P.A. is best qualified in this field when he is able not only to develop sound opinion on accounting matters but as well to understand the philosophy of legal rules of evidence. About 35 years ago a prominent trial lawyer, after commending an auditor for an effective presentation of opinion testimony, said that he had always used with reluctance two classes of "expert witnesses," namely surveyors and accountants. "The accountant, when he finds that two columns of figures when added produce the same total, will swear that the books, being in balance, are most certainly right. The surveyor, when he finds a set of field notes can be plotted so the perimeter of a tract of land is closed, will be ready to swear that the field notes are all correct." We hope the last thirty-five years has changed the view of most accountants in this respect.

From personal experience over a period of active participation as an expert witness in many fields relating to accounting, I feel that the C.P.A. can play a most important part. Some of my experiences relate to the following:

The application of a railroad to discontinue its passenger run between two major cities as being non-profitable was disallowed by the Public Utilities Commission based primarily upon our testimony.

In a criminal case involving conspiracy to rig bids, important testimony was given by us as to the methods by which overhead could be properly computed.

We have appeared as expert witnesses to testify as to proper accounting treatment where an accounting firm has been charged with improper application of accounting theories. In these instances the judge relied on our testimony as a guide for his own information as to the proper procedures.

In another instance, on the basis of our testimony, the court held that a tort claim was not to be included as a current asset, resulting in a sufficiently decreased ratio of current assets to current liabilities as to come within the proviso of a bond indenture that turned over the control of the company to a Bondholders Committee. This happened to be a historical case resulting in a judgment of many million dollars against the officers of the company.

I am not including the numerous times that I have appeared

as an expert witness in cases in connection with the detection of fraud. For the past thirty years I have made numerous investigations for the Prosecutor's Office.

I have testified before a Senate Investigating Committee regarding the determination of hospital costs in connection with the establishment of reimbursable Blue Cross payments. I have frequently been called upon to testify in litigated matters as to methods for the determination of goodwill.

One of the principal requirements, it would appear to me, for a person to truly be an expert witness is not only his technical knowledge but his ability to transmit that knowledge in understandable terms to his listeners. An expert witness must have the ability not only in his manner of self-expression but must also develop an expertise in the art of demonstration. It is most important to know how to properly use charts, graphs or tables to clearly demonstrate technical usages.

The certified public accountant's place as an expert witness is definitely growing in stature in our jurisprudence system. In situations involving income taxes, costs, casualty losses, etc., we have witnessed some outstanding performances by certified public accountants in court. In fact, members of our staff have made sterling expert witnesses. However, when it comes to attesting under oath as to generally accepted accounting principles, we have seen some rather sad performances. When the national firms have many definitive views and positions and render the same opinion under different sets of circumstances, this area gets a little difficult.

Attorneys who have *cross-examined* C.P.A.'s have frequently expressed their delight at the C.P.A.'s lack of flexibility; his strained efforts at finite definition and boundaries; and generally, his lack of capacity to communicate.

I do not think that a C.P.A. who does not have the ability to *integrate* his client's best interests with the *varying* levels of accounting theory should ever undertake to act as an expert witness. He can become a positively harmful influence to his client's case, absent the qualifications in paragraph one. A good, flexible C.P.A., who can withstand the challenge of cross-examination, and can communicate, is a pearl beyond price. . . .

Question 24

Is there anything you particularly want to say to a financial executive or the business world about our profession or its practice?

International and National Firms. The answers to this question are necessarily varied but, in general, they stress the need for better understanding between business and the accounting profession.

Representative Answers. The only message that I want to give the business world is that without a strong, independent accounting profession that the public can rely upon, the accounting and financial practices of business will be controlled by government.

It is in the businessman's interest to inquire deeply into the broad economic and social functions of accountancy as well as its capabilities for serving his decision-making functions; professional accountants need the stimulus of challenging questions from businessmen. It is, of course, the C.P.A.'s responsibility to be alert to every possible opportunity to improve the meaningfulness of data upon which business decisions rely. But if business leaders do not make the effort to comprehend the full scope of accounting analysis, C.P.A.'s may not be able to make their maximum contribution to the financial operations of business enterprise; it's a two-way proposition.

The public accountant should be used for purposes other than the annual audit. He should be consulted from time to time for discussion of financial and tax matters—used as a sounding board for new ideas and new activities and generally for discussion of business matters.

Regional Firms. These answers stress the need for more cooperation between client and accountant, better understanding and better public relations. Some discuss unfair competition and the deficiencies of the profession.

Representative Answers. It seems to me that the average local practitioner is not so much interested in the business

world in general as in his own business area in particular. And in that area he is faced with many types of unrestricted competition. The local practitioner meets his adversary with his hands tied behind his back. The public accountant and the unethical C.P.A. engage in competitive bidding; the "business engineer" solicits clients and carries out an extensive advertising and promotional program to sell our clients a service we are capable of performing; several data processing service bureaus are operating within a radius of 200 to 250 miles of our office and are openly soliciting clients of ours as well as many potential clients; "estate planners" are coming into our area regularly and soliciting our clients (and selling many). Perhaps the problems confronting the smaller firm are considerably different than those of the larger firms. But, as ethical practitioners we cannot fight back against this type of competition. Our only possible way to compete is to be able to get the message over to our clients in a *direct* manner. And this cannot be done by writing a letter to each one of them (some 1,000) each year. We need a continuing program of public relations (or client relations) and such a program must be on a direct basis between the accountant and client. A public relations program dealing in generalities on the profession level will not do the job. In this area our firm is capable of rendering services that no other firm in the area can competently render. Consequently, a public relations program designed to benefit all of the firms in general would not be broad enough to cover all of our services. We need to communicate directly with our clients and tell them what we can do for them.

Income tax law, based as it is on net income, must necessarily reflect the complexities of the economic system—the variety of ways of earning a living or making a profit. Similarly, financial statements of businesses making those profits, also exhibit the complexities of the economic system. It is from these circumstances—from these transactions and these results—that accounting principles must be derived, and in turn applied. Simplicity, conformity, standardization of reporting are difficult to obtain to any substantial degree, and on the whole are illusory. Given an appreciation of the kind of economic com-

plexities with which accountants and financial statements are concerned, adequate disclosure and explanations are necessary for the understanding of financial statements, and much more so for their relevant comparison with those of other enterprises or periods.

The following is probably not a four-square answer to your question, but it represents my major observation for our profession: We are too much concerned with uniformity, with rigid rules and fixed standards; with LIMITING our responsibility; with routines of Inventory tests and Receivables confirmation; all of which is oddly INCONSISTENT with our endeavor to ENLARGE our functions toward counselling in management. Small businesses, in particular, stand more in need of broad-gauge counsel than OPINION audits.

Yes—there should not be an instinctive negativism to C.P.A. firms who lack national repute. C.P.A.'s should be considered qualified, unless proven otherwise. In no other profession (law, engineering) is size of firm so emphasized in relation to *quality* and *professional status* of firm.

It has been our experience in the past few years that a number of important industrial concerns have been using small practitioners who have been completely incompetent to give adequate accounting services and advice. They have failed to grow with their clients. In each instance where we have gotten into these matters we have found much corrective work had to be done. In most of these instances, certified reports had not been issued and banks had accepted them. Had the banks refused to accept these statements and insisted upon proper audit reports, these industrial organizations would have been spared much grief. In many instances it was necessary to delay SEC filings for a number of years because of accounting inadequacies that had to be corrected. We believe that the banking profession has done a disservice to the accounting profession by its failure to give more than lip service to the need for accurate reporting. It is also our opinion that a large stratum of the financial world has failed to recognize the fact that the cost of accounting services should not be viewed as a measure with

those of a highly trained bookkeeper. We find too frequently that proper recognition is not being given in terms of fees for the proper value of services given.

The president of a local bank with seventy million in deposits, who is a graduate of the Wharton School of Finance, astonished me recently by stating that he didn't have time to read all the fine print and was interested only in what the balance sheet showed. It is obvious that we have failed to educate this banker on how to read an auditor's report.

B

Glossary of Terms Used in Statistics and Operations Research[1]

Analog Computer. A computer in which numbers and mathematical relationships are represented by physical counterparts. For example: (1) in a slide rule the logarithm of a number is represented by distance; (2) certain differential equations can be solved using a disk in contact with a rotating wheel. In most commercial analog computers, numbers are represented by electrical voltages. Accuracy in computation is limited by the manufacturing tolerances of the components.

Bayesian Decision Theory. Formal procedures for revising currently held probabilities in the light of additional information. Sometimes interpreted to mean methods for modifying previously held beliefs in the light of sample evidence, when making judgments in the face of uncertainty.

Bias. A persistent error in one direction as opposed to a random error. A method of sampling or measurement is biased

[1] Except for those marked with an asterisk (*) the definitions used in this glossary are adapted from the glossary of the same title included in the book *Understanding Operations Research* published by The Canadian Institute of Chartered Accountants in September, 1963. Permission to use this material is gratefully acknowledged.

if the average of a large number of observations does not tend to the true value but to some other value.

Critical Path Method (CPM). A method of network analysis that can be used to indicate the trade-off between the cost and duration of a project. The critical path is that sequence of activities through the network which must be expedited if the project duration is to be shortened.

Cybernetics. The name (coined by Wiener, 1947) applied to the entire field of study in control and communication theory of machines, animals, men, and mixed systems. The name was instituted to foster recognition of the theoretical unity of such studies, and is generally employed when emphasizing this aspect. It thus relates to the study of organization.

Decision Theory. The theory that deals with decision-making under uncertainty and seeks methods for selecting the "best" strategy (or alternative) from a set of possible strategies (or alternatives).

Deterministic Model. A model in which chance or probability plays no part. Outcomes (and variables such as sales) are assumed to be completely predictable. Compare with probabilistic model.

Digital Computer. A computer so constructed that numerical calculations are carried out on quantities that are expressed as digits, the number of digits used, and hence the accuracy of the calculation, being limited by the capacity of the computer. Most desk calculators are simple digital computers.

*Direct Costing. A method of determining periodic income. Under direct costing all costs are classified as either direct or periodic; and then further classified as manufacturing or non-manufacturing costs. The direct manufacturing cost, direct material, direct labor, and the variable portion of manufacturing overhead are assigned to products and matched with revenues from these products at the time the products are sold. All other costs are assigned to the period in which they are incurred.

Exponential Smoothing. A method of mathematically weighting and smoothing past observations for forecasting purposes in which the heaviest weight is placed on the most recent information. One of its major advantages is that only one figure need be retained from one period to the next.

Frequency Distribution. The pattern formed when the value of a variable is plotted against its probability (relative frequency) of occurrence. The mathematical representation (or function) of this pattern is called the probability density function.

Normal Distribution. The well known symmetric or bell-shaped distribution, which is fully characterized by its mean and variance. Also called the Gaussian distribution, it is one of the most commonly used distributions because of (a) the large number of situations in practice where this distribution is found to approximate the behavior of variables, (b) the ease with which this density function can be handled mathematically.

Poisson Distribution. A widely applicable distribution for the frequency of occurrences per unit (for example, the number of visual defects per manufactured unit, or the number of arrivals per hour at a serving counter).

Game Theory. An extension of the theory of probability to provide optimal strategies for situations of conflict in which each participant attempts to advance his own interests at the expense of his opponents.

Inventory Control Theory. The use of mathematical and statistical methods to answer the questions of when and how much to order, such decisions being optimal with respect to a given measure of effectiveness, for example leading to minimum inventory management costs.

*Linear Programming. A method of solving problems in which there are a main objective that involves maximizing or minimizing a characteristic; interacting variables; and, usually, other objectives in conflict with the main objective. In a business situation, the main objective might be minimum cost; and

the variables might be customer orders, machines, products, marketing areas, and transportation modes. A conflicting objective might be that all customer orders must be delivered within a certain time period. The interactions between the variables must be such that the algebraic relationship between them can be expressed or approximated in linear equations. This technique is applied in developing solutions to problems involving the allocation of a resource within constraints imposed by various aspects of the situation.

MATRIX. An array of numbers (or symbols) arranged in rows and columns. When there are m rows and n columns, the array is called an $m \times n$ matrix (read, "m-by-n").

MATRIX ALGEBRA. A mathematical shorthand in which matrices instead of numbers are manipulated to facilitate the manual solution of certain problems.

MODEL. A representation of a system that can be used to simulate (or predict) the behavior of the system. A model may be constructed of symbolic relationships, mathematical relationships, or physical analogs (see Analog Computer). For example, a planetarium is an analog model of the solar system.

OPERATIONAL GAMING. A general term used to describe the simulation of operational decision-making through the use of a model or game, for example war games and management games. The consequences of many decisions can be observed and analyzed, and conclusions can be drawn through repeated "plays" of the game.

PARAMETER. A quantity that characterizes a general class of systems or models, in which an individual value defines a specific case. Thus (a) the radius is a parameter in the equation of a circle; (b) interest rate is a parameter in the model: interest earned = (interest rate) times (amount of money invested).

PERT. A contraction of Program Evaluation and Review Technique. A method of network analysis that uses three time estimates for each activity and gives an expected completion date for the project with a probability range about it. Can be

used continuously to monitor the schedule status. Originally developed for research projects where time estimates were difficult to make.

Population. A collection of items or events about which conclusions are made, generally on the basis of a sample. For example, one refers to the population of invoices prepared by a department in a year, or the population of individuals in the market for a certain product. Also called universe or field.

Probabilistic Model. A model in which chance plays a role. Outcomes and/or uncontrolled factors (such as sales) are random variables that must be represented by probability density functions instead of single values. Also called a stochastic model. Compare with Deterministic Model.

Profitability Accounting. Defined as an accounting system that can satisfy the needs of financial accounting and managerial accounting through unification and integration of a number of concepts and techniques. These would include a capacity for absorbing systems of profit planning and responsibility accounting. It must further be capable of absorbing applied techniques such as profit contribution analysis, standard costs and flexible budgets, and return on investment analysis. It must also be designed to produce reports for management that depict meaningful representations of performance as compared with the plans and measures of performance appropriate to the organization and the responsibility level of the manager to whom the report is issued.

Programming (Mathematical). A method of finding the mathematical maximum (or minimum) of a function whose variables are subject to one or more constraints.

Dynamic. This technique reduces the problem of optimizing N stages simultaneously to one of solving N one-stage problems.

Heuristic. This kind of programming is designed to explore the nature of the problem as well as to determine the maximum (or minimum).

Integer. Only whole numbers may be considered as possible solutions.

Linear. The function and constraints are expressed in linear terms only.

Parametric. The optimum value of a function is found for a variety of values of the parameter(s) to indicate the sensitivity of the solution to changes in the parameter values.

Quadratic. The function and/or constraints contain some terms of second degree but no higher.

Stochastic. Random elements are present in the function and/or the constraints.

*Quality Control. A system of inspection, analysis, and action applied to a process or service so that by inspecting a portion of the whole output of the process or service an analysis of its quality can be made. On the basis of the analysis, action may be required to achieve and maintain an established level of quality. Inspection and analysis are usually performed by quality control departments, although inspection procedures are frequently designed into operations by quality control specialists for use by operation personnel. The actions indicated by quality control analysis are usually taken by operating personnel. Quality control can be applied as a preventive tool to minimize defective output of the product or service involved.

Quantify. To express in terms of numbers that reflect relative magnitude.

Queuing (or Waiting Line) Theory. The theory that develops models for systems in which "customer" arrival and/or processing time cannot be precisely predicted. With such models, different levels of facility capacity can be compared for such as utilization percentage and average waiting time.

Regression Analysis. Statistical methods for estimating or predicting the value of one factor (the dependent variable) from values of other factors (the independent variables).

Multiple Regression. There are two or more independent variables.

Linear Regression. The independent variable(s) are represented by linear terms only in the prediction equation.

Curvilinear (or Non-Linear) Regression. At least one of the independent variables is represented by a quadratic or higher degree term in the prediction equation.

*Responsibility Accounting. Responsibility accounting is a system of accounting in which the accounting structure is designed to fit the organization structure. Within such a system, organization plans and reports of performance can be compiled within the framework of the accounting structure and related to individual managerial responsibility.

Simulation. Use of a model to reproduce the behavior of a real system under various alternative conditions.

Statistical Design of Experiments. The theory that uses mathematical and statistical principles to so design experiments that (a) they are efficient, that is, the ratio of information obtained to work expended is high, and (b) the amount of work carried out is consistent with the objectives (including calculated risks).

Statistical Quality Control. The system used to "control" quality by applying statistical techniques to inspection data. In practice the term has come to mean the philosophy of "making it right in the first place." Inspection results are used to locate sources of trouble, and control is applied at these points through the use of control charts or otherwise.

Synergy. The phenomenon (caused by interactions) wherein the whole is greater than the sum of the parts. For example, the result of a simultaneous expenditure of $50,000 on advertising and $25,000 on increasing the sales force may be greater than the sum of the results obtained if these same expenditures were made at different times.

System. An array of components designed to achieve an objective according to plan. The system may be structured or

loosely defined, manual or automatic. For example, the billing system in a department store comprises the people, office machines, and forms required to bill the customer for his purchases. Similarly a heating system in a home is made up of the furnace, heating units, and the control unit (thermostat).

TRANSPORTATION PROBLEMS. A class of linear programming problems that seeks the minimum cost schedule for shipping a product made or stored (in limited quantities) at several different locations and required at a variety of destinations. The transportation method is a simplified linear programming approach to this problem.

UNIVERSE. Same as Population.

VARIABLE. A factor the value of which varies (or may be varied) in a problem under consideration.

VARIANCE (STATISTICAL). A measure of the spread of a frequency distribution or a body of data. Denoted by "sigma squared." Note that this meaning differs from that generally used in accounting.

C

Statement on Auditing Procedure[1]

To the Members of the
American Institute of Accountants:

Gentlemen:

Under date of May 9, 1939, the council of the American Institute of Accountants adopted a report submitted by the special committee on auditing procedure entitled "Extensions of Auditing Procedure," and at the same time it was anticipated that the committee would make a supplemental report at the September meeting. The report of May 9th emphasized that it was the ultimate responsibility of the independent certified public accountant to adopt such procedures as in his professional judgment he deemed appropriate, but recommended that certain additional procedures regarding inventories and accounts receivable should be considered as generally accepted practice. It further recommended that, where these additional procedures regarding inventories and accounts receivable had not been undertaken, that fact should be disclosed in the auditors' report or opinion.

The action of the council received widespread support of

[1] Statement No. 1, *Extensions of Auditing Procedure,* issued by the Committee on Auditing Procedure, American Institute of Accountants. Copyright 1941 by American Institute of Accountants.

state organizations of certified public accountants, and the recommendations evoked the hearty approval of investors, credit grantors, the press, and the public.

During the four months which elapsed between the issuance of the report and the September meeting, the committee had considerable discussion and correspondence with informed people, both within and without the profession, and held a number of meetings. While the recommended additional procedures had the united support of independent accountants, it was evident that there was some misconception as to the meaning intended to be conveyed by the term "physical tests" as applied to inventory quantities, that considerable misunderstanding had arisen as to the responsibility which the auditor might be assuming, and that the recommended reference in the auditors' report of opinion to the omission of such procedures had been misconstrued.

In its supplemental report presented to council under date of September 18th, the committee explained the term "physical tests" and indicated that in his capacity as auditor the independent certified public accountant could properly attend at the inventory-taking and observe the methods of taking the inventory, making in conjunction therewith such suitable inquiries or requiring such test checks under his observation as he deemed advisable, and that such a program was within the meaning of the term "physical tests."

The auditor's duty was increased in that the additional procedures were adopted as generally accepted practice wherever they are practicable and reasonable, but beyond this the auditor's responsibility remained unchanged. The responsibility of the management for taking proper inventories was again emphasized.

The committee reiterated its recommendation of May 9th that, where exceptions were required, such exceptions should be expressed clearly and unequivocally. However, where exception was not called for under the terms of the report, it was felt that no good purpose would be served by requiring negative explanations, because discussion and experience in the meantime had demonstrated that negative references in the auditors' report gave rise to misconception in that they tended to convey implications of reservations or exceptions where none

existed or was intended. In other words, they had the effect of casting an unwarranted cloud on the statements.

The council at its meeting on September 18, 1939, adopted the supplemental report of the committee which, after discussion at the meeting of the Institute on September 19th, was approved. The executive committee was authorized and instructed by council to coordinate the two reports into one document and to distribute it to the membership. This document is submitted herewith; it supersedes the report of May 9, 1939.

Respectfully submitted,

EXECUTIVE COMMITTEE

By: John L. Carey, *Secretary.*

October 18, 1939.

EXTENSIONS OF AUDITING PROCEDURE

Report of May 9, 1939, as Modified and Approved at the Annual Meeting, September 19, 1939

Following the adoption by council on May 9, 1939, of the report of the special committee on auditing procedure entitled "Extensions of Auditing Procedure" and the approval at the annual meeting of the supplementing and interpreting report of the same committee dated September 18, 1939, the executive committee was instructed by council to coordinate the two reports into one document and to distribute it. There is presented herewith the modified report which deals with the following matters:

Examination of inventories
Examination of receivables
Appointment of independent certified public accountants
Form of independent certified public accountants' report

Auditing procedures and related matters dealt with herein relate to those cases in which financial statements are accompanied by a report and opinion of an independent certified public accountant. Accordingly, that which follows should be read in the light of this limitation.

At the outset it is pertinent to state that, since the late dis-

closure of conditions existing in exceptional cases, certified public accountants have been considering possible implications which may arise therefrom in relation to their practice. The committee desires to state its opinion that auditing procedure has kept, and continues to keep, pace with the growth and development of industry and that the well established custom of making test checks of accounting records and related data and, beyond that, reliance upon the system of internal check and control after investigation of its adequacy and effectiveness has with very few exceptions proved sufficient for its purpose. Because of public interest and discussion in the press, there is a question now before the profession as to whether its procedures shall be extended. In order to consider the question intelligently there must first be some general understanding of certain fundamentals.

In the performance of his duties as auditor, the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees, to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and the results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocally.

Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts, for the proper recording of transactions in the books of account, and for the safeguarding of the assets of a concern. It is also charged with the primary responsibility to stockholders and to

creditors for the substantial accuracy and adequacy of statements of position and operations.

In order to qualify himself to carry out his function, the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice, he encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements.

The independent auditor must also exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. Experience shows that, with few exceptions, the personnel of business organizations is honest. The ordinary examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant is not designed to discover all defalcations, because that is not its primary objective, although discovery of defalcation frequently results. In a well organized concern the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control. It is the duty of the independent auditor to review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in

detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises—a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry.

In carrying out his work the independent certified public accountant must always be on his guard against collusive fraud and be alert in detecting any sign of such collusion. However, on the basis of his examination by tests and checks, he relies upon the integrity of the client's organization unless circumstances are such as to arouse suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion.

Turning now to consideration of the specific matters referred to at the beginning of this report, it may be noted in passing that in some cases independent certified public accountants have attended at the inventory-taking or observed physical test checks of inventories and have confirmed receivables by direct communication with debtors. Such steps, however, have usually been undertaken as additional procedures under arrangement with the client, or where the accountant thought them essential or desirable in a particular case.

It is believed that recognition should be given to the widespread demand for an extension of auditing procedures with regard to inventories and receivables. However, it should be noted that additional expense to business will be involved in the added procedures.

Inventories

Added steps may well be taken to give greater assurance with regard to inventories. The extent of such additional pro-

cedures will necessarily vary with the circumstances, because the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories. But, however extensive these may be, the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials. The public should understand that, while he can in his capacity as an auditor undertake additional procedures as to inventories, such procedures do not invest his opinion with a degree of authority which he does not claim for it or impose upon him a measure of responsibility which the nature of his work does not justify. Such procedures are only for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition.

Taken in consideration with the foregoing discussion of auditing procedures, the following recommendations are made concerning inventories:

(A) That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records, he shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation.

In cases where the inventory is determined solely by means of a physical inventory at the end of the accounting period (or at a date prior or subsequent thereto but within a reasonable time thereof, with adequate records supporting the interim changes), it will ordinarily be necessary for the foregoing procedures to be followed at that time.

In cases where the concern maintains well kept and controlled perpetual inventory records supported by (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items taken from time to time so that the quantity of each item on hand is compared with the inventory record for that item at least once in each year, it will be satisfactory to undertake the procedure outlined at any interim date or dates selected by the auditor, his purpose being to satisfy himself as to the credibility of the perpetual-inventory records and whether they may be relied upon to support the inventory totals as shown on the balance-sheet.

(B) That hereafter, in the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from such custodians is acceptable procedure; except that, where the amount involved represents a significant proportion of the current assets or of the total assets of a concern, the independent certified public accountant shall make supplementary inquiries.

It should be clearly understood that in undertaking these auditing procedures regarding inventories, the independent certified public accountant does so for the purpose of satisfying himself as to the credibility of the representations of the management regarding quantity and condition and does not hold himself out as a general appraiser, valuer, or expert in materials.

The general adoption of such added procedures regarding inventories may necessitate procedural changes on the part of clients. So many corporations close their books upon a calendar-year basis that it is doubtful whether the profession as at present organized can undertake the additional work adequately and satisfactorily on the last day of each year. Many corporations do not have adequate perpetual-inventory records and greater use of them should be encouraged.

The extension of procedures regarding inventories would be greatly facilitated if each concern adopted its natural business year instead of the calendar year as its fiscal year, and introduced continuous well kept perpetual inventory records.

The proposed changes will take time to bring about, and in the meantime the profession may well be faced with the neces-

sity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures.

Receivables

In regard to the question of confirming receivables by direct communication with the debtor, the following recommendation is made:

That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

Appointment of Independent Certified Public Accountants

Apart from the specific phases of auditing procedure which have been the subject of consideration, the method of appointment of the independent auditor and his status in relation to the client are believed to be subjects of great importance to stockholders and creditors.

To emphasize the auditor's independence of the management, some corporations affected by public interest have adopted the practice of having the independent auditor engaged or nominated by the board of directors or elected annually by the stockholders. Other corporations have provided that the stockholders be given an opportunity to ratify the selection made by the directors.

It is suggested that the auditor should be appointed early in each fiscal year so that he may carry out part of his work during the year.

Form of Independent Certified Public Accountant's Report or Opinion

The services which independent auditors render usually culminate in a report, which may take varying forms. In some cases a detailed report is rendered, accompanied by statements and supporting schedules; in other cases the report is limited to a concise statement of the scope of the examination and the related opinion of the independent auditor concerning the accompanying financial statements of the client. For present purposes the discussion is confined to the short form of auditor's report, which is sometimes described as a certificate. The terms "report," "opinion," "report and opinion," and "certificate" have been used interchangeably. As uniformity is desirable, either of the words "report" or "opinion" is recommended for general use. The word "report" has been adopted in the following comments.

In January, 1934, the Institute issued a pamphlet entitled *Audits of Corporate Accounts*, dealing with a standard form of auditor's report. The short form of report then recommended, and since widely adopted by the profession, met a long-felt need.

Developments during the five years in which the standard form of report has been used indicate the need of revision in the interest of clarity. The revised short form of report consists of two paragraphs. The first contains a brief statement of the scope of the examination, and the second deals with the auditor's opinion on the financial statements of the client as a result of his examination.

The major changes recommended pertain to the description of the scope of the examination, specifically to include reference to the system of internal control. The phrase "obtained information and explanations from officers and employees of the company" has been omitted because it is inherent in all auditing procedure to obtain information and explanations from officers and employees concerning the accounts, either as supplementing information obtained from other sources or as constituting the only available information on the subject. In the latter case, the auditor must decide, in view of all the circumstances, whether he should rely upon such information without

disclosure of the source. The phrase in question has led to serious misconception as to the degree of reliance on such information and explanations. The sense of the statement "but we did not make a detailed audit of the transactions" has been retained in a revised form. It will be recalled that this clause was included in the standard form of 1934 in order to make clear that the auditor's usual procedure consisted of testing and sampling rather than a detailed audit. It is believed that the business and financial public now fully understand that, in a well organized concern, the detection of irregularities is primarily a matter of internal procedure, and that testing and sampling to determine whether such procedure is adequate in scope and effective in operation is the usual practice of the independent auditor. Nevertheless, it is considered advisable for the purpose of emphasis to include the phrase, "without making a detailed audit of the transactions." There has been excluded the phrase "based upon such examination," as it is obvious that the independent certified public accountant can express an opinion only after he has completed the work set forth in the first paragraph of the report.

The independent certified public accountant should recognize that in some cases the revised short form recommended may not be altogether appropriate. For instance, there may be cases where the auditor may prefer to alter the first sentence of the standard short form, substituting some words to the effect that the accounting records (instead of the financial statements) have been examined. Obviously, also, it would be erroneous to mention internal control if none existed. Accordingly, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use, but should be adapted to the needs of the particular case. For example, the report may be used in connection with an examination covering a period of years, in which case a modification of language would be necessary. Also, in new engagements appropriate investigations relating to prior years will have to be made to justify the use of the short-form report. However, in the interest of reasonable uniformity it is recommended that the substance of phrases in the standard form be used unless inappropriate.

In considering the independent certified public accountant's

opinion, the reader should bear in mind one of the most important underlying concepts of financial statements, viz., that normally many of the assets of a concern are not realizable in cash, but are commonly stated at their historical cost or going-concern basis at amounts which are usually greater than the realizable value in forced liquidation. Again, the true profit or loss of a concern can be determined with accuracy only over its entire existence. Therefore, in any attempt to allocate to specific periods profit or loss applicable thereto, it must be recognized among other considerations that, as many transactions are not fully completed within such periods, the result as shown must contain many estimates and approximations in the endeavor to present fairly the operating results of a period in conformity with generally accepted accounting principles.

Assuming that normal procedures have been carried out, it is not considered necessary to describe the details of the examination in this form of report. Any such details as are given should be included in separate paragraphs of the report. For example, reference may be made to procedures which the accountant has adopted regarding the examination of inventories and receivables; also, it may be pertinent to mention the fact that certain portions of the auditor's work have been carried out at different times during the course of the year. This may be indicated by inserting the words "at times" in the first paragraph of the short form of report immediately after the words "by methods."

It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.

In explanation of the general principles governing the auditor's opinion, with particular regard to explanations and exceptions, it is pertinent to state that the auditor satisfies himself as to the fairness of the statements "by methods and to the extent he deems appropriate," in general conformity with the auditing procedures recommended in the Institute's bulletin

Examination of Financial Statements. Ordinarily, if he has so satisfied himself, he is in a position to express an unqualified opinion. However, if he considers it in the interest of clear disclosure of material fact to include explanations of procedures followed, he is free to do so. If, on the other hand, such disclosures are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report. As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.

It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception.

It is the responsibility of the accountant—and one which he cannot escape—to determine the scope of the examination which he should make before giving his opinion on the statements under review. If in his judgment it is not practicable and reasonable in the circumstances of a given engagement to undertake the auditing procedures regarding inventories and/or receivables set forth in this report as generally accepted procedure and he has satisfied himself by other methods regarding such inventories and/or receivables, no useful purpose will be served by requiring an explanation in his report. If physical tests of inventories and/or confirmation of receivables are practicable and reasonable and the auditor has omitted such generally accepted auditing procedure, he should make a clear-cut exception in his report.

It is worthy of repetition that the extent of sampling and

testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests, and inquiries. Depending upon his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination. Consequently, in some cases it may be necessary to modify or omit reference to reliance upon the system of internal control. Clearly also where a detailed examination is made, the phrase "without making a detailed audit of the transactions" would be inappropriate.

It is contemplated that, before signing a report of the short-form type suggested, the independent certified public accountant will be satisfied that his examination is in conformity with the procedures and practices outlined in *Examination of Financial Statements,* a bulletin published by the American Institute of Accountants in January, 1936, or in any subsequent revision thereof.

The report should be addressed to the board of directors or the stockholders if the appointment is made by them.

The description of the financial statements in both paragraphs should, of course, conform to the titles of the accompanying statements.

In consideration of the foregoing remarks the following short form of report is recommended:

Short Form of Independent Certified Public Accountant's Report or Opinion

To the Board of Directors (or Stockholders) of the XYZ Company:

We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying balance-sheet and

related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It is worthy of repitition and emphasis that, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use but should be adapted to the needs of the particular case.

Special Committee on Auditing Procedure

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C. Oliver Wellington

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Terms used in statistics and operations research are not included in this index but are listed alphabetically in Appendix B, page 199.